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MISCELLANEOUS TAX BILLS—1988

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 1239, S. 1821, S. 2078, S. 2409, S. 2484, S. 2611, H.R. 1961, and H.R. 2792

JULY 12, 1988

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MISCELLANEOUS TAX BILLS—1988

TUESDAY, JULY 12, 1988

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:43 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable Max Baucus (chairman of the subcommittee) presiding.

Present: Senators Baucus, Matsunaga, Daschle, Packwood, Danforth, and Chafee.

[The press release announcing the hearing and a description of tax bills (S. 1239, S. 1821, S. 2078, S. 2409, S. 2484, S. 2611, H.R. 1961, and H.R. 2792 follows:]

[The prepared statements of Senators Daschle and Armstrong appear in the appendix.)

[Press Release No. H-28, June 30, 1988]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ANNOUNCES A HEARING ON MISCELLANEOUS TAX BILLS

WASHINGTON, DC—Senator Max Baucus (D., Montana), Chairman of the Senate Finance Subcommittee on Taxation and Debt Management, announced Thursday that the Subcommittee will hold a hearing on the following miscellaneous tax provisions:

S. 1239, to provide for use of the cash method of accounting with respect to certain short-term loans.

S. 1821, to provide that certain services performed in the processing of fish or shellfish do not constitute employment for Federal tax purposes.

S. 2078, to require a majority of employees to approve the establishment of an Employee Stock Ownership Plan.

S. 2409, to provide a mechanism for taxpayers to contribute overpayments of income tax and other amounts to the National Organ Transplant Trust Fund.

S. 2484, to enhance the incentive for increasing research activities.

H.R. 1961, as reported by the House Committee on Education and Labor, to provide for the portability of employees' pension benefits after termination of employment.

H.R. 2792, which has passed the House and has been referred to the Committee on Finance, to preserve certain Indian fishing rights.

An original bill ordered to be reported by the Veterans' Affairs Committee to allow the Veterans' Administration access to third party tax data to verify income information of persons receiving means-tested VA benefits.

The hearing is scheduled for *Tuesday, July 12, 1988 at 9:30 a.m.* in Room SD-215 Dirksen Senate Office Building.

In announcing the hearing, Baucus said, "The Subcommittee has received a number of requests for hearings on miscellaneous tax bills. These hearings will give the Subcommittee an opportunity to examine these bills more closely and to hear from parties who are likely to be affected by the legislation."

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator **Baucus**. The hearing will come to order. We welcome you to today's hearing on tax bills, particularly miscellaneous tax bills. In addition, this hearing will cover a bill that Senator Danforth and I have introduced to revise the method for computing the R&D tax credit. It is a bill that has been drafted over the past several months in an effort to resolve some of the perennial criticisms that have been raised against it, although I think the basic idea has been very sound.

I think we have solved some of these suggestions, and I compliment Senator Danforth, as well as the Administration and various persons involved directly in the R&D tax credit, for what I think is a very sound bill.

This legislation also has drawn considerable praise from various sources as an improvement. I hope it reflects a growing understanding of the importance of R&D efforts to the international competitiveness of America's economic growth.

There is no question that increased R&D efforts must be made if this nation is to maintain its competitive position in the world economy. Testimony before this subcommittee in April 1987 indicated that the current R&D based structure sometimes can discourage R&D spending. That testimony led to the legislation before this committee today, and hopefully this hearing will move this proposal one step further toward enactment.

The subcommittee also will hear testimony on a number of other miscellaneous bills. Two of them would affect the rules for qualified retirement plans; another would provide an exemption for small banks from some of the tax rules for short term loans, and one that would ensure that Indians are not taxed on income from fishing.

We have a series of other bills, too, and I look forward to the testimony, of course. Our first witness is the Honorable Senator Inouye; is the Senator here? (No response)

I do not see Senator Inouye.

Senator **Danforth**. Senator Evans is here, and Congressman Jeffords is here.

Senator **Baucus**. All right. Why don't you, Senator, and Congressman Jeffords, both come forward? Why don't you, Dan, proceed first?

STATEMENT OF HON. DANIEL EVANS, A U.S. SENATOR FROM WASHINGTON

Senator **Evans**. Thank you, Mr. Chairman. I am delighted to appear before this committee in support of H.R. 2792, a bill that provides that income earned by Indian tribal members exercising fishing rights guaranteed by treaty, statute, or executive order is exempt from taxation under State or Federal law.

I do recommend that the committee instruct its staff to work with the staff of the Select Committee on Indian Affairs in drafting its report so that the committee report reflects the work which the Select Committee has devoted to understanding the effects of this bill on existing principles of law affecting Indians.

The Internal Revenue Service began levying taxes on income derived from treaty fishing. The Select Committee on Indian Affairs reported out S. 727, a bill that would clarify that income derived from the exercise of treaty fishing rights is not subject to taxation.

The Administration supported a congressional clarification of this issue and made a commitment not to commence enforcement actions while Congress considered clarifying legislation. The House Parliamentarian ruled that S. 727 was a revenue measure which necessarily must originate in the House, even though we have passed the equivalent of S. 727 twice in the Senate.

Subsequently, several Congressmen introduced H.R. 2792, a companion bill to S. 727. H.R. 2792 defines the scope of the tax-exempt status of income derived from the exercise of treaty fishing rights. The bill further attempts to clarify the relationship of the exemption to treaties.

Essentially, I agree with the scope of the exemption as defined by the bill, but my concerns about the bill as now written rest on its consistency with established principles of Indian treaty construction.

Mr. Chairman, I would ask that my entire statement be included in the record. The next several paragraphs deal in some technical detail with this issue, but I will not read them here.

Senator BAUCUS. Without objection.

Senator EVANS. Let me turn to the crux of the matter. The dispute between the Department of the Interior and the Internal Revenue Service arises out of an inherent tension between two applicable long-standing canons of construction.

First, regardless of the circumstances, exemptions from Federal income taxation be "clearly expressed"; and second, that treaties and statutes affecting Indians are to be interpreted liberally in light of the trust responsibility of the United States and bearing in mind the Indians' historically inferior bargaining position which characterize negotiation of their treaties.

Unfortunately, the courts have not been wholly consistent in describing how the balance between these canons of construction should be struck. As a result, the Internal Revenue Service continues to prosecute Indian fishermen for failing to pay a tax that the Interior Department says the Indians do not owe. Tragically, Indian people are caught in the middle.

The argument that an exemption must derive explicitly or implicitly from treaty language is in direct opposition to these principles. It is illogical to the extreme that a Federal tax exemption must derive from specific treaty language when such treaties predated the Federal income tax by several decades.

Furthermore, if the treaties contain no language upon which to construe a specific tax status and if the Congress has never expressly abrogated impediment-free treaty fishing rights as to taxation, then the tribes' right to fish free of such taxation was not conceded to the United States but was reserved by the tribes.

S. 727, the bill twice passed by the Senate clarifying this tax status, was carefully drafted to comport with these established principles of Indian treaty construction and case law. I agree that the scope of the exemption is such that income derived from the exercise of protected fishing rights is exempt only to the extent clarified in the bill; but I urge the committee to carefully review this measure and especially Section 1(c)(3) to ensure that they are consistent with these principles and that the bill does not abrogate reserved treaty rights.

Mr. Chairman, I am grateful for this opportunity to testify in support of H.R. 2792. I hope that we can act expeditiously so that Indian treaty fishermen, in our part of the country at least, will have an opportunity to continue their fishing without the sword of Damocles of the IRS constantly poised over their heads.

[The prepared statement of Senator Evans appears in the appendix.]

Senator **Baucus**. Thank you very much, Senator. Before we proceed to questions from members of the committee, I would like Congressman Jeffords to give his statement first. Then we will proceed.

STATEMENT OF HON. JAMES M. JEFFORDS, A U.S. REPRESENTATIVE FROM VERMONT

Congressman **Jeffords**. Thank you very much, Mr. Chairman. I am here to testify on H.R. 1961 dealing with pension portability. I have just come from a hearing in the House Ways and Means Committee, where we discussed the same bill. This bill has already passed the Education and Labor Committee in the House.

For 14 years now, we have been talking about what to do about pension portability. To me, it seems time that we take some positive action. There are very complicated problems involved with portability—whether or not to give service credits or subsidies or provide indexing in connection with the treatment of defined benefit plans, etcetera. The legislative plan that we present to you today is a simple one, dealing only with the preservation of assets.

This action is needed now more than ever, primarily because of a shift in the demographics of our work force. We have fewer and fewer workers each year relative to the number of senior citizens. It is therefore incredibly important that we have present funding for the future needs of our senior citizens.

Also, due to the increased mobility being created in our work force, more and more are in need of some sort of a portable pension plan. This has been emphasized most recently, of course, in connection with both plant closings and corporate takeovers. Also, we have new problems of an increased number of cashouts stemming from the new vesting rules which will I think, commence next year. This makes more urgent the consideration of legislation with the portable pension aspects.

I have an entire statement, which I will ask to have put in the record, but I would like to give to you some additional information, plus a bit of a synopsis of what the bill tries to do.

First of all, with respect to the bill, the Department of Labor ERISA Advisory Council in a March 1988 report substantially endorsed the principles of the bill, and we have worked very hard with the Administration to come up with something which was consistent with their criteria.

Second, the Office of Technology Assessment in May of this year also came up with recommendations which are pretty much embodied within H.R. 1961.

What does the bill do? In several specific ways, the proposal encourages a form of voluntary portability for existing tax qualified pension plans. First, the current law prohibition on the direct transfer of employee contributions from pension plans to IRAs is removed. The Pension Portability Act would permit all or a portion of the terminated employee's benefits under a qualified plan, including the employee's own after-tax contributions—and that is important to know—to be transferred tax-free directly from the plan to a portable pension plan.

Second, unless pensions are paid in annuity form, the direct transfer from qualified plans to a portable pension plan would become the presumptive form of distribution. Not all plans, but at least those qualified plans that allow for single-sum distributions would have to provide employees who are eligible for distribution under the plan with an option to transfer their benefits. Such sums would be made to a portable pension plan in a direct trustee-to-trustee transfer.

A plan would be allowed to provide this portability transfer option as the only option or as one of other distribution forms, including the joint and survivor form as under current law. Also, if the qualified plan provides, employees would be permitted to elect out of the portability transfer option and receive their benefits in another form allowed under the plan.

To encourage the employee and the employee's spouse to utilize the tax-free portability transfer, the plan must provide an explanation of the possible adverse tax consequences of not taking such a transfer.

Third, the plan sponsors would be allowed to reduce their recordkeeping burdens by transferring the pensions of terminated employees to portable plans. Thus, the portability of pensions in any amount would be encouraged by permitting plans without obtaining employee or spousal consent to make such transfers.

This procedure would be allowed, and the current $3,500 restriction would be eliminated because the receiving portable plan would be treated as a transferee plan that protects any spouse and provides a core set of distribution options.

Finally, the portability of pension amounts between plans would be improved. Direct trustee-to-trustee transfers would always be allowable under portable plan IRAs, and as under current law, previous rollovers or transfers from qualified plans to IRAs, which are separately accounted for, may be transferred back to qualified plans of the same type.

In addition, I would point out that CBO has provided us with the cost estimate on this with respect to revenue. There would be no cost for the first years because the effective date is postponed until after 1991.

In addition to that, there would be less than a $50 million impact for the fiscal years 1992 to 1993. And finally, I would point out that the revenue tax impact is only deferred, in that it would result in increased tax revenues when the pensions funds are distributed to the employee.

I would hope that the committee would take a serious look at this bill. I have the expectation that the Ways and Means Committee will look at it. As I noted, it has already been passed by the Education and Labor Committee.

I thank the Chairman and the committee for allowing me to appear here this morning to testify.

[The prepared statement of Congressman Jeffords appears in the appendix.]

Senator **Baucus**. Thank you very much, Congressman.

Senator Evans, you said that your bill has twice passed the Senate. Is that correct?

Senator **Evans**. That is correct. It is in a different form. This bill, H.R. 2792, has passed the House of Representatives and is now in front of us as a House bill because of the ruling of the House Parliamentarian that it must be a House bill because revenue is involved.

Senator **Baucus**. Thank you. Congressman Jeffords, from the point of view of international competitiveness, some argue that it is better for employers to adopt policies to keep their employees so that their employees will want to stay at the company, that is with retraining and expanding new products, rather than laying off people or letting people go to try to find new jobs.

So, I am wondering from the point of view of international competitiveness, do you think portability helps to make America more competitive or might detract?

Congressman **Jeffords**. It helps to make it more competitive. My legislation certainly does not detract from the advantages of a defined benefit plan and the ability of employers to use such a plan to keep their employees with them.

But we have to recognize right now that employees are already shifting jobs and this movement is accelerating. In order to provide them with a substantial idea that they will have a pension plan which is viable and will stay with them through their working career to give them the kind of ability to be able to take care of their later years, I think it is an incentive to keep people in those particular occupations which are most mobile.

Thus, they will have an opportunity to stay in those occupations and have a viable pension plan. I am talking about engineers and others who have a tendency to move as the demands of their particular businesses change.

Senator **Baucus**. According to our early bird rule, the first Senator here, and who is next in line to ask questions is Senator Danforth. Senator Danforth?

Senator **Danforth**. No questions, Mr. Chairman.

Senator **Baucus**. Senator Matsunaga?

OPENING STATEMENT OF HON. SPARK M. MATSUNAGA, A U.S. SENATOR FROM HAWAII

Senator **Matsunaga**. Thank you, Mr. Chairman. Now, Senator Evans, H.R. 2792 appears to take Indian tribes with fishing income outside of the Federal tax system. Are you in any way concerned that the legislation would fail to protect such groups with regard to unemployment compensation and/or the FICA tax?

Senator **Evans**. I don't believe so, Senator. The bill deals specifically with income taxation. It is sort of the reverse side of benefits which do flow to Indian tribes.

We have a difficult time sometimes trying to understand that unique relationship between Indian tribes, on the one hand, as separate governments with which the United States signed treaties, and the fact that Indians are citizens of the United States as well.

But in the case of the northwest particularly, where Indian tribes reserve the right—reserve the right—to fish, you know, frankly, they didn't reserve the right as much as they gave up certain things, but retained other rights. And the retained rights were those of fishing without interference, and those are clearly stated in the treaties. And I believe that we simply must recognize that.

Frankly, I would hope that the committee looks very carefully at the very specific wording of S. 727 as it was passed compared to the somewhat different wording in the same section in the House bill. And I believe that, at least in committee language and probably in the bill itself, we should consider going back to the Senate language which I think much more clearly sets forth that right, which I think must be set forth clearly.

Senator **Matsunaga**. No further questions, Mr. Chairman.

Senator **Baucus**. Senator Daschle?

Senator **Daschle**. No questions, Mr. Chairman.

Senator **Baucus**. Thank you both very much for your testimony.

Senator **Evans**. Let me add just one other thing to Senator Matsunaga's question, which I did not indicate. The concept of treaty right fishing is important. There are many Indians who fish outside of their treaty rights; and in doing so, they fish just as fisherman of any other kind would fish and would be subject to the same kinds of taxation.

So, it is a very clear and a very narrow interpretation that I think is important for us to understand.

Senator **Matsunaga**. So, your provision would be strictly within the treaty rights?

Senator **Evans**. That is correct; and outside of the treaty rights, fishing would be subject to income tax just like anyone else.

Senator **Matsunaga**. Fine, thank you.

Senator **Baucus**. Thank you both very much. Is Congressman Hal Daub here? (No response)

All right. We will proceed to our next witness, who is the Honorable Dennis E. Ross, Deputy Assistant Secretary for Tax Policy of the Department of the Treasury. Mr. Ross, you are speaking in place of Secretary Chapoton?

STATEMENT OF HON. DENNIS E. ROSS, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. Ross. I am; as his deputy I am standing in for him today.

Mr. Chairman, it is a pleasure to be here to present the views of the Treasury Department regarding the miscellaneous bills that are the subject matter of this hearing; and they include, of course, S. 2484, extending the research credit; H.R. 1961, addressing portability pension benefits; S. 2078 and S. 2291, relating to employee approval of ESOP plans; H.R. 2792, the tax treatment of Indian fishing rights; S. 1239, treatment of certain short-term obligations held by certain banks; S. 2611, relating to the provision of tax return information to the Veterans' Administration; and finally, S. 1821, which would exclude certain seafood processors from the definition of "employee" for Federal income tax purposes.

Mr. Chairman, let me turn first to S. 2484, the Research and Experimental Credit Extension Act of 1988, introduced by yourself and Senator Danforth. Because research spending is essential to fostering technological innovation, which is the major source of growth and productivity, the Administration is committed to encouraging growth of private domestic research activities.

And to this end, we strongly favor a permanent R&E credit and strongly support the efforts of those, such as Senator Danforth and yourself, who are attempting to improve the effectiveness of the R&E credit.

As you know, the current credit was enacted in 1981. It was extended in the Tax Reform Act until the end of this calendar year. The rules governing the current credit are detailed in my written statement, but its basic features are a 20 percent credit rate with a credit base equal to the excess of current R&E expenditures over the average of R&E expenditures incurred by the taxpayer for the prior three years.

The base may never be less than 50 percent of the current qualified R&E expenditures. There are, in addition, a number of rules defining R&E expenditures eligible for the credit, including specific exclusions for research performed outside of the United States and research relating to style, taste, cosmetic, or seasonal design factors.

The credit is further restricted to research paid or incurred in carrying on a trade or business of the taxpayer. As a result, new corporations and corporations entering new lines of business cannot claim the credit.

As you know, the Ways and Means Committee has tentatively agreed in its markup of the Technical Corrections Bill to extend the current R&E credit for two years. At the same time, in an effort to reduce the revenue cost of this two-year extension, the Ways and Means Committee has also agreed to reduce the taxpayers' deductions under Section 174, by the amount of the taxpayer's R&E credit allowed in the particular year.

Let me turn to a description of the Danforth/Baucus bill, which is designed to increase the R&E credit's incentive effect and at the same time to increase the number of taxpayers that are eligible for the credit. The bill would retain the incremental feature of the present credit and also the present 20 percent rate; but it would make the credit permanent, and it would modify the calculation of the base for the credit's purposes.

The new base would be a fixed historical base equal to the average of a firm's qualified R&E expenditures over the period 1983 to 1987; and it would be indexed annually by the average increase in the gross national product.

Firms also would have the option of a separate seven percent credit for expenditures over 75 percent of that new historical fixed base amount; as with current law, all firms would be subject to a 50 percent base limitation.

This proposed credit would also apply a less stringent trade or business test so that new firms and firms entering new lines of business could claim the credit, without regard to the trade or business test, if the taxpayer intended to use the results of the research in the conduct of a present or future trade or business.

Mr. Chairman, prior Treasury testimony before this subcommittee has identified certain weaknesses in the structure of the present R&E credit. While we continue to believe that the R&E credit is an important stimulant for economic growth and productivity, we have also been studying ways to restructure the credit so as to improve its incentive effect.

The Danforth/Baucus proposal is consistent with our own views as to the optimal credit structure, and we believe it can have a significant and important effect in encouraging R&E. As you know, the President has proposed a permanent R&E credit in his 1989 budget at a revenue cost that would be equal to an extension of the current R&E credit.

Although it remains the Administration's first priority to prevent expiration of the R&E credit, we would support an R&E credit, as modified in the Danforth/Baucus bill, if that proposal were made revenue-neutral to an extension of current law; and thus consistent with the President's budget recommendation.

As I will discuss later, we believe that the revenue cost of the Danforth/Baucus bill can be reduced without sacrificing that bill's structural improvements to the R&E credit.

Let me turn to the features of the Danforth/Baucus credit which we think are indeed very positive, and the most important of these is the replacement of the current credit's moving base with a fixed base structure. We believe this fixed base structure results in a five-fold increase in the incentive effects of the credit per dollar of revenue cost.

It is now widely acknowledged that an incremental credit with a base equal to a moving average of prior expenditures, such as the current credit, leads to an effective rate of credit which is only a fraction of the statutory credit rate. Indeed, our analysis, as well as that of others, indicates that the average effective rate of the current R&E credit is about two percent, even though the statutory rate is 20 percent.

This relatively small effective rate is again primarily attributable to the current credit's moving base since a firm's additional R&E in one year increases its base for future years and thus effectively decreases the credit the taxpayer earns in future years. Thus, R&E generating a dollar of credit in one year will cause a 33.3 cent reduction in credits available in each of the next three years.

As my written statement describes in somewhat greater detail, the effect of the moving base of the current credit can actually turn the effective credit rate negative so that the R&E credit actually encourages firms to reduce in certain cases R&E expenditures.

The Danforth/Baucus bill would address this problem of low and, in some cases, even negative incentives by tying the credit to a fixed 1983 through 1987 base; and again, that base would be indexed to nominal GNP. As a consequence of this fixed base, a firm's current spending has no effect on its ability to generate future credits.

The Danforth/Baucus bill would also significantly increase the percentage of R&E-performing firms eligible for the credit, and this increase is achieved through the design of the primary and alternative credit bases, which results in a larger number of firms with R&E expenditures above base.

The goal of the tax credit for R&E is to encourage a firm to invest in R&E at a level higher than it would absent the credit. In the absence of the credit, all firms would ordinarily determine the amounts of R&E spending simply by weighing the cost of the R&E against its potential benefits.

Now, if we knew that each firm would spend X dollars in the absence of the credit, the most efficient credit would provide a tax reduction to all firms for expenditures above their respective X dollar amounts. That is, it would locate the credit incentive at the margin.

Although there has been much debate about how the credit should be distributed among firms with high, low, or even negative growth rates in R&E, the credit is most effective if it encourages all firms, regardless of whether their X dollar amount, that is, the amount they would otherwise spend in R&E, is declining or increasing.

Unfortunately, this X dollar amount for every firm cannot be known; and in designing a credit base, some judgment must be made about the behavior of firms with respect to R&E expenditures. The three-year moving base of the current R&E credit assumes that firms steadily increase R&E investment over time so that their X dollar amounts are always in excess of their prior year's expenditures.

Although this model may well reflect the usual behavior of larger firms, which tend to show steady growth in R&E expenditures, smaller firms have more varied spending patterns. A small firm may have only one or two research projects for which optimal expenditures may increase or decrease greatly, depending on the particular phase of their research cycle that is faced in the current year.

Treasury studies and also a General Accounting Office study indicate that the moving base of the current credit results in approximately one-third of R&E-performing firms being ineligible for the credit in any one year.

There are, I should point out, some tradeoffs in designing a credit base so as to expand the availability of the credit.

Senator BAUCUS. Mr. Ross, I am wondering if you can shorten your statement. I appreciate very much your support of the R&E tax credit provision, but we have a lot of other witnesses. Could you please make your testimony a little more concise because I know you have other comments you want to make on some other bills.

Mr. Ross. All right. I do, although I would say, Mr. Chairman, by far the most lengthy comments I have are on the credit proposal; but let me try and make my statement more concise.

Again, we believe the effect of your bill to expand the availability of the credit is an important one, and that is accomplished both through the alternative base structure and by the relaxation of the trade or business requirement, which would thus make the credit available for startup businesses and businesses entering new lines of business.

The credit proposal you have offered also has an important advantage in removing inflation as a factor affecting the amount of the credit that a firm earns. Your proposal effectively indexes the credit base by GNP—nominal GNP—which would include both an inflation factor and a real growth factor.

Again, that is a very positive improvement in the credit since, under current law, the credit is not indexed with reference to inflation. The amount of credit that a firm earns—the effective amount that it earns—will depend on inflation; and that introduces a variable which simply again generates uncertainty for the firm and diminishes the incentive effect of the credit.

I should also note the fact that your proposal makes the credit permanent. That is something that the Administration strongly supports.

Let me turn to the modifications that we would request in the credit and that would be necessary, in our view, for the Administration to support it; and these modifications are again intended to limit the revenue cost of the proposal and make that conform with an extension of the current credit.

What we would propose is that, similar to what was done in the Ways and Means Committee markup, a reduction in a taxpayer's deductions for research expenditures be required equal to the amount of credit generated in a particular year. We believe that has a sound tax policy basis.

As my written statement describes in some detail, it tends to make equivalent the tax system's treatment of alternative forms of support for research, support provided in the form of the tax credit as opposed to support provided in the form of a direct cash grant. It would make the tax treatment of those benefits effectively neutral.

I would emphasize, however, that our support for this deduction disallowance is limited to the context of the Danforth/Baucus proposal. We would not support it in the context of a proposal such as the Ways and Means Committee's tentative proposal, which is simply an extension of current law.

We believe that the effect of reducing deductions is, as a practical matter, the same as reducing the rate of the credit; and that is a reduction that would concern us if it were simply in a context of an extension of current law. Since there are other advantages to your proposal, which we believe would more than offset this effective reduction in the statutory rate of the credit, we think the net effect of the package would still be to strongly improve the incentive effects of the R&E credit.

Mr. Chairman, with that, let me turn to the other bills. Again, I will here try to keep my remarks very brief.

The next on my list was H.R. 1961, addressing the question of pension portability. The Administration's view here is a concise one, and that is that this is an area of enormous importance and substantial complexity; and frankly, we think that efforts to legislate in this area at this time are premature.

With particular reference to H.R. 1961, certain of its provisions might conceivably enhance pension portability, but its major feature—the requirement that employers in certain circumstances distribute pension benefits to an IRA—would not necessarily improve pension portability and could in fact disadvantage employees.

We are additionally concerned about the provisions in H.R. 1961 which would expand the ability of certain employers to offer simplified employee pensions, which we fear could undermine the nondiscrimination rules currently applicable to other qualified plans. That is because the nondiscrimination rules applicable to simplified employee pensions are somewhat more liberal.

Our basic concern in this area, however, is that it not be addressed in a piecemeal fashion and that, prior to attempting to draft or enact legislation addressing the problem of pension portability, Congress and the respective administrative agencies give the matter careful study. There are, as I am sure you are aware, a number of important issues involved.

Let me turn to S. 2078 and S. 2291, which would establish employee approval requirements for ESOP plans. As you know, a number of tax incentives in current law are offered to encourage the establishment of ESOP plans and certain transactions involving ESOPs.

The oft-stated justification for these incentives is that ESOPs provide employees an equity ownership interest in their employers and thus increase employee productivity and company profitability.

As I say, S. 2078 and S. 2291 would require a majority of the employees of an employer establishing an ESOP to approve establishment of the plan. There would also be a provision permitting the Secretary of the Treasury to provide that an ESOP participant's voting rights, required under Section 409(e) of the Internal Revenue Code, are not satisfied unless those voting rights with respect to securities allocated to the participant's account are substantially similar to the voting rights of holders of the same or similar classes of securities.

Treasury supports the underlying purpose of these bills, which we view as providing ESOP participants with the same stock ownership rights as other holders of similar classes of stock. As I indicated earlier, there are substantial incentives for ESOPs in the current law.

We do not believe this committee should reexamine the appropriateness of those incentives, but nevertheless there are questions about whether the existing ESOP rules provide employees with a degree of control over their stock that is consistent with their true ownership of the stock.

The bills seek to enhance employees' control of their stock in two ways. The first is the requirement of majority approval by employees for the establishment of an ESOP. We do not see that this directly provides ESOP participants with more substantial stock ownership rights.

The requirement could have this effect since employers might provide more substantial stock ownership rights in order to secure employee approval of an ESOP plan; but it is possible that employees would use the leverage of this approval requirement to secure other benefits, which have nothing to do with stock ownership rights.

In this case, the approval requirement would not serve what we understand its intended purpose to be. We are also concerned that the approval requirement interferes with the historically voluntary decisions of employers to establish compensation levels or to establish employee benefit plans.

The second and more targeted effect of these bills is to require ESOPs of closely-held corporations to permit participants to vote the shares allocated to their accounts on all matters for which other shareholders of the same type of stock are entitled to vote. As you know, such equality in voting rights is already required for ESOPs which hold publicly traded securities.

We believe this more targeted requirement is an appropriate means to ensure that ESOP participants have substantial ownership rights with respect to their stock. I should note that this is also a question falling under the jurisdiction of the Labor Department, and I believe they will be submitting a written statement to you on this matter.

Let me turn, Mr. Chairman, to H.R. 2792, addressing the taxation of Indian fishing rights. Indians are generally subject to Federal income tax to the same extent as other persons. Any exemption from tax must be derived from treaties or agreements with Indian tribes or Federal tax statutes or some other Act of Congress.

As Senator Evans testified, under a variety of treaties, Indians have been granted fishing rights, generally construed to include the right to fish for commercial purposes, as well as for subsistence purposes. Since these treaties predated the establishment of the Federal income tax, they do not expressly address the question of taxation of Indians' income from fishing.

A number of courts considering this issue have held that fishing income of Indians is not tax-exempt. This bill would amend the Code to exempt from tax income derived by a member of an Indian tribe from the exercise of treaty-established fishing rights. The bill would be effective for all years and thus would resolve current disputes between the IRS and Indian taxpayers.

We recognize that the issue of taxation of income derived by Indians from the exercise of fishing rights is of great concern to Indian tribes throughout the country, particularly in the northwest and Great Lakes areas. The Indians who were parties to the treaties likely understood that under the treaties they would be able to fish on the same basis as before, when they were neither required to pay taxes nor turn any portion of their catch over to the Federal Government.

The Administration supports H.R. 2792, which would honor the Indians' understanding of the treaties. I should emphasize, however, that we do not believe this provision should serve as a precedent for conferring tax-free status on other income derived by Indians from other sources.

Fishing serves a number of unique and important functions in Indian cultural and religious life and thus may be distinguished from other types of activities engaged in by Indians; and these activities would remain fully taxable under the provisions of H.R. 2792.

Turning to S. 1239, which addresses the treatment of certain short-term obligations, Section 1281 of the Code requires certain taxpayers to accrue interest income on short-term obligations; and this requirement applies to all accrual-basis taxpayers and to dealers in such obligations, banks and regulated investment companies, regardless of whether those specifically named taxpayers are otherwise on the accrual method.

For taxpayers not subject to Section 1281, a companion provision, Section 1282, requires a deferral of interest expense on purchases of short-term discount obligations that are debt financed. S. 1239 would exempt banks, not otherwise using an accrual method of accounting, from the provisions of both Section 1281 and Section 1282 with respect to the loans made in the ordinary course of their business.

We do not support S. 1239. The accrual method of accounting is generally accepted as the most accurate method of accounting for income. Accrual accounting is thus appropriately and generally required throughout the Code, except in circumstances where the additional complexities that can be created by the method outweigh the additional accuracy that the method generates.

Congress has previously decided that, in the case of certain taxpayers, including specifically banks, it was appropriate to require accrual of income of discount on short-term obligations. Banks, including small banks, were made subject to this requirement because they are generally sophisticated taxpayers, able to handle the complexity of the accrual method; and this relates both to their financial systems generally and to the financial instruments in which they routinely deal.

Banks in many cases report their income from short-term obligations on an accrual basis for nontax purposes. Thus, applying the provisions of Section 1281 to banks is not going to impose and does not impose unreasonable administrative burdens; and we see no reason to exempt banks from the accrual requirement of Section 1281.

This is particularly so since the revenue loss from creating an exemption for banks from Section 1281 would presumably have to be offset with revenue raised from other taxpayers.

With that, let me turn to S. 2611, relating to disclosure of tax information to the Veterans' Administration. As you know, under Section 6103 of the Code, the IRS is required to disclose certain tax return information upon the request of a variety of agencies or individuals, including Federal and State tax administrators and certain other Government agencies.

The IRS is not, however, currently required to disclose tax return information to the Veterans' Administration; and this bill would require the IRS to do so.

Mr. Chairman, on this issue, I do not speak for the Administration, which has this issue under review; and I am expressing to you strictly the views of the Treasury Department. We oppose this bill since we believe it represents a piecemeal relaxation of the confidentiality requirements of Section 6103.

This section serves the important function of assuring taxpayers that their returns are confidential, which is in turn an important element of our voluntary compliance system, since taxpayers could well be discouraged from submitting fully accurate and honest returns, if they knew the information submitted would not be protected from disclosure.

Thus, while we are sympathetic with the needs of the VA for return information, we would hope that Congress would not further liberalize Section 6103 without a comprehensive examination of the policies behind that provision and the extent to which granting additional exceptions from the confidentiality requirement may affect taxpayer compliance.

Mr. Chairman, finally, let me turn to S. 1821, which provides an exception for certain seafood processors from the definition of "employee" for Federal tax purposes. Under current law, an employer is required to withhold from its employees' wages Federal income tax and the employee's share of FICA and FUTA taxes. These taxes only apply with respect to employees.

We oppose S. 1821, which would treat seafood processors who are, in fact, employees and thus subject to these withholding requirements as self-employed individuals for Federal tax purposes. This treatment would be both unfair and burdensome to seafood processors and detrimental to the Federal tax system.

If seafood processors are treated as self-employed individuals, they would be required to pay taxes under the Self-Employment Tax Act an amount that is now approximately equal or would eventually be—I should say in two years it would be—approximately equal to the sum of the current employers' and employees' portions of the FICA tax.

So, in time, there would be a net additional burden on seafood processing employees. The employers of the seafood processors would pay no FICA or SECA taxes for these employees. Seafood processors who are not operating their own businesses and who are unaccustomed to keeping business records would be required to file additional tax forms and remit therewith Federal income and SECA taxes.

This is neither an efficient nor a fair way to collect Federal taxes from seafood processors' employment.

That concludes my prepared remarks, and I would be pleased to address any questions that you may have.

[The prepared statement of Mr. Ross appears in the appendix.]

Senator MATSUNAGA. Thank you very much, Mr. Ross.

Senator Danforth, any questions?

OPENING STATEMENT OF HON. JOHN C. DANFORTH, A U.S. SENATOR FROM MISSOURI

Senator DANFORTH. Mr. Chairman, thank you very much. Mr. Ross, we have frequently held hearings about the research and development tax credit in the past and whether it should be permanent or whether it should be extended for a period of years.

Although Congress has never made it permanent—I don't think we ever did, did we?

Mr. ROSS. No.

Senator DANFORTH. And we since extended it in the 1986 Tax Act. The testimony has always been that businesses make research decisions over a period of time and that, to have a two or three year period in which the law exists, does not give sufficient time for long-term planning by the business. Does Treasury accept that proposition? Would you rather have a permanent extension than an extension for two years or three years?

Mr. ROSS. We strongly support that proposition. R&E is, in its nature, long term. Companies make decisions about expenditures over a period of time. If they only know the credit is available for the first year or the first two years or whatever, the intended incentive effect of the credit is simply diminished.

And if you just do piecemeal extensions, you are really not getting what you are paying for in terms of an incentive for R&E. We would strongly support making the credit permanent.

Senator DANFORTH. All right. Now, you testified that the proposal that Senator Baucus and I have would yield a five-fold increase in the incentive affect per dollar of revenue loss. Is that the entire proposition, or is that simply the effect of the use of a fixed base as opposed to a floating base?

Mr. ROSS. That is the effect of using a fixed base as opposed to the moving base. If you would like to look at the entire effect of the proposal, there is attached to my written statement a table, Table 1, which addresses the general incentive effect of the proposal in relation to dollar-of-revenue cost. I believe that is page 11 of the testimony.

Senator DANFORTH. All right. Page 11? I have Table 1 here, Summary of R&E Credits and so forth.

Mr. ROSS. That is right. If you look at that, the middle column of that table attempts to identify the incentive effect of the credit under a variety of formulations. One is the tentative Ways and Means agreement; two is current law; and three is your own proposal.

And if you compare the effect of current law versus your own proposal, the relation there is really on the order of six to one rather than five to one. I think the dominant effect in terms of improving the incentive is really the substitution of a fixed base for a moving base, but the entire proposal has an additional positive effect.

Senator DANFORTH. Now, the Administration has opposed substantive changes in the law in the Technical Corrections Bill, but the one exception has been the extension of the R&D credit. I take it that either the extension of the credit or this reworking of the credit would continue to be the sole exception as far as the Technical Corrections Bill?

Mr. ROSS. That may be a little strong, Senator. The President's budget has a couple of other substantive items in it. One is the R&E credit, as you point out; but there is additionally a provision relating to the sourcing of R&E expenditures, the so-called "67 Percent Solution."

There is also actually a permanent resolution of the problem affecting the two percent floor as it applies to regulated investment companies; but we have generally strongly encouraged the adoption of technical corrections; and I think we have previously indicated that, if it is necessary to delete all substantive provisions to do that, we are prepared to do that.

There are a number of substantive provisions that we could support.

Senator DANFORTH. All right, but it is a fair statement that the Administration—you do speak for the Administration on this issue, do you not?

Mr. ROSS. Oh, on this issue? Certainly.

Senator DANFORTH. Yes. It is fair to say that the Administration would view it as a significant loss to U.S. research and development if we allowed the R&D credit to vanish.

Mr. ROSS. Yes, definitely.

Senator DANFORTH. And further that it would be a roughly sixfold increase in the effectiveness of the R&D credit if we modified it in accordance with the proposal that Senator Baucus and I have introduced?

Mr. ROSS. Yes. Again, we have revenue sensitivity to the exact form of your proposal.

Senator DANFORTH. I understand that, and I know of no objection to working that out. As far as I know, that is perfectly satisfactory. But assuming that—

Mr. ROSS. Yes. We would offer as much support as we possibly can for that. We think it is very important certainly to the competitive position of U.S. firms and the overall growth of this nation's economy and the productivity of its capital investment and work force. This is very important to the Administration, and we strongly support it.

Indeed, as I testified, we are very supportive of the modifications you offer. We think they offer enormous improvement to the credit.

Senator DANFORTH. Thank you very much, Mr. Ross.

Senator BAUCUS. Senator Matsunaga, any questions?

Senator MATSUNAGA. Yes, Mr. Chairman. Mr. Ross, what puzzles me is that, as I understand it, the Treasury is opposed to sharing of information among agencies, even where sharing of such information would save one agency, such as, say, the Veterans' Administration, from making payments which probably would not need to be paid, amounting to millions of dollars.

Now, why is this policy of the Treasury?

Mr. ROSS. Senator, that is a very good question, and I think you put the issue very well. Since there is clearly a benefit that can be gained from providing tax return information to the Veterans' Administration and presumably to other agencies as well.

Our concern is, in a sense, a long-term concern. We are the tax administrators, and we have a long-term concern with the soundness of our system of tax administration and the voluntary compliance system on which it is based. Our concern in this area is that, if you weaken the confidentiality requirements that currently protect taxpayer returns, you will over the long term erode taxpayers' willingness to supply fully accurate and honest information to the IRS.

And if you do that, in the long run you will see substantial revenue losses. Since we cannot, as administrators of the system, raise revenue on our own, we are very much dependent on the voluntary compliance of taxpayers.

So, while I agree with you that there would clearly be a short-term benefit to the Veterans' Administration, we are concerned that there will be a long-term cost to the Government and to the tax system. Now, it is possible that that long-term cost will not be significant and that this additional relaxation by allowing return information to go to the VA would not be unwise.

We don't want to rule out the possibility that this is a provision that would make sense. We are concerned, however, that decisions like this not be made in a piecemeal fashion, that Congress consider carefully what it is doing in this area, and the sort of guidelines that should control the release of information to other Federal agencies.

And we want, in that process, Congress to be very much aware of our concern that, if you simply provide tax return information to whomever is interested for whatever good and noble reason, in the long run you are going to do some significant damage to the voluntary compliance system; and that is simply a concern we want to make sure that Congress has carefully before it, before it takes action in this area.

Senator MATSUNAGA. But I am informed that GAO has estimated that returns or return information of 80 million taxpayers now are subject to disclosure under Section 6103. The bill under consideration would increase the number of taxpayers whose returns are subject to disclosure by 1.6 million. Isn't that correct?

Mr. Ross. I don't know about the 80 million figure, but I believe the figure about how much this bill would increase disclosure is accurate. Again, it is not necessarily this bill in isolation that is a bad thing or a bad idea.

There is an incremental effect there, though; and if Congress allows additional disclosure every time an agency comes forward and says this will only add one million additional taxpayers to the disclosure file and that really in and of itself is not a bad thing, over time, you are going to have a cumulative effect, which is serious.

Again, we would like Congress to approach this issue with true deliberation and taking a long-term look at what it is doing. It may well decide that, on balance, it makes sense to provide information to other agencies. Again, we would like Congress in making that decision to be aware of and concerned about the ultimate effect on the tax system.

Senator MATSUNAGA. Another question, Mr. Ross. The Administration has proposed in its fiscal year 1989 budget that the R&D tax credit be made permanent and that taxpayers be allowed to allocate a greater portion of their research expenses to U.S.-source income. Now, how does the Administration propose to pay for these changes, given that the major revenue raiser included in the budget submission—that is, the extension of the Medicare payroll tax to State and local government employees—has been repeatedly rejected by this committee and by the Congress?

Mr. Ross. We would hope that Congress would in time come to see the wisdom of that proposal. Recognizing that that may not necessarily happen this year, I cannot really offer you any additional revenue raisers.

I believe the Assistant Secretary will be here tomorrow to discuss with you and the full committee the question of possible revenue raising measures. He may perhaps have some ideas to discuss with you at that time.

At the moment, let me simply reiterate that we view the Medicare extension proposal as sound tax policy. This is a group that, for the most part, already receives Medicare benefits. The fact that they don't pay into the Medicare system is simply unfair and lays the cost of that system disproportionately on certain recipients of the benefits; and we would urge the committee to consider that.

If that is not plausible, as I say, there may be and the Assistant Secretary may discuss tomorrow additional alternatives. If there are no such alternatives, then I think the Administration is in the position of saying, then, even its own submissions in terms of the R&E credit or other provisions would simply not go forward.

Senator MATSUNAGA. Lest I be misunderstood, I am a strong proponent of R&D because I feel, in the long run, R&D will truly broaden the taxation base. No further questions, Mr. Chairman.

Senator BAUCUS. Mr. Ross, you had some problems with the Veterans' Affairs bill in the abstract, that is theoretical problems. I am wondering if you know of any evidence that disclosure of tax information to a nontax agency, like the Social Security Administration, does in fact result in reduced taxpayer compliance.

What is the evidence, not the theory; what is the evidence?

Mr. ROSS. Mr. Chairman, it is a hard subject to produce specific evidence on. The Service is currently actively engaged in a study of exactly that question; and I assume, through taxpayer surveys and other analyses of data, are attempting to produce more specific evidence that will either document that concern or not.

At this point, I can't offer specific evidence, and I can only mention to you the study which we hope, in the next year or so, would be able to produce evidence on that subject. But again, you shouldn't lightly regard the theory since what is at stake is substantial; and I think it is plausible, just thinking about it again abstractly, to think that taxpayers would—if they recognize that the information they give to the service will not simply establish tax liability but expose them to a variety of other possibly negative effects—will be more cautious and less likely to come forward with accurate and honest information.

But you are right certainly to press for evidence, and we are trying to provide it; at the present time, though, I don't have it.

Senator BAUCUS. I want to thank the Administration for its support of the bill offered by Senator Danforth and myself on the R&D tax credit and particularly for your very strong expression of Administration support today, subject to the deduction credit provision. I just want to thank you very much for that support, and I think we will work it out this year and get it passed.

Mr. ROSS. I appreciate that, Mr. Chairman. I think we really could make a significant improvement in this area, and we appreciate your support and are glad to be of assistance to you in this effort.

Senator BAUCUS. Thank you very much, Mr. Ross. We appreciate your testimony. Our next witness is a very patient Congressman Daub.

STATEMENT OF HON. HAL DAUB, A U.S. REPRESENTATIVE FROM NEBRASKA

Congressman DAUB. Actually, I don't mind, Mr. Chairman, because I get a chance to give Mr. Ross a copy of my testimony and make sure he reads it.

Mr. ROSS. I will carefully do that.

Senator BAUCUS. Congressman, go ahead. We are glad you are here.

Congressman DAUB. Thanks very much. I am glad to be here, and I will be concise. Members of the committee, thank you for the opportunity to testify before you today regarding the imposition of accrual accounting on short-term loans held by banks.

On May 7th, I introduced legislation, H.R. 2323, to allow cash basis banks to continue to use the cash method of accounting for tax purposes for short-term loans. The companion bill, Senator Daschle's bill, S. 1239, was introduced in the Senate shortly thereafter.

The 1984 Deficit Reduction Act required that acquisition discount on short-term obligations be accounted for on the accrual basis by cash basis banks. A technical amendment to the 1984 Act included in the 1986 Tax Reform Act extended the original issue discount rules in the 1984 Act to include interest on short-term obligations—and now I quote: "irrespective of whether the interest is stated or is in the form of acquisition discount or when the interest is paid."

It is my position that the OID rules in the 1984 Act did not apply to the accrual of interest on short-term loans where interest was based on a fixed rate and payable at fixed periodic intervals over the term of the instrument. The technical correction to the 1984 Act, therefore, was not technical at all, but instead a retroactive change in the law expanding Section 1281 of the Code to require the accrual of any interest—I want to underscore the words "any interest"-including stated interest on short-term obligations regardless of the taxpayer's method of accounting.

It is my strong feeling that Congress, and in particular my committee, Ways and Means, instead addressed the treatment of cash method taxpayers in a fully debated provision of the 1986 Tax Reform Act, Section 801. This provision repealed the cash method of accounting after December 31, 1986, for taxpayers with gross receipts in excess of $5 million. This provision fairly and sufficiently addressed the problem and should be considered as the overriding intent of Congress.

Without this interpretation of the law, the exemption for small businesses with less than $5 million in gross receipts results in a meaningless exception for small banks. It makes no sense to me to implement Section 1281, forcing the recognition of all interest income for all obligations of less than one year without any spread of that income. This is grossly unfair, particularly when a normal change in method of accounting would result in at least a three-year spread of that income.

Second, the unfairness of this rule is amplified by the rate structure and deferral rules. While cash method banks in general are allowed a four-year spread under the 1986 Tax Reform Act, those banks affected by this rule must recognize a large amount of their income, but not their expense, in the first year that the rule applies, 1986.

For many banks in the Midwest, particularly farm banks, agriculture banks, small banks, these loans can be as much as 90 percent of the bank's entire loan portfolio. Not only is there no relief from the bunching of the income, but the tax is imposed at the higher rates then in effect for 1986.

Third, let me point out that many of these small banks with less than $5 million gross receipts will decide to change their method of accounting so that they can accrue their current expenses against their current income.

Unfortunately, they must make this election within six months of the taxable year, meaning 1989 at the earliest. The result is an even greater hardship because expenses will be spread out over a 6-year period under the current rules, meaning that small banks will have to wait 6 years to realize their losses, while their gains all fall in a single taxable year.

Fourth, this provision causes a very burdensome accounting problem for all these institutions. This is because banks do not keep track of loans based on their duration—in this case, one year or less under Section 1281. In order to go back and amend their returns, the administrative cost to look at every single loan will be expensive.

Fifth, most of these small banks have a tough enough time keeping up with the sweeping changes in the 1986 Tax Reform Act. This little known provision will result in extensive penalties and interest charges dating back to 1985.

I find this kind of retroactive, obscure rule with accompanying penalties very unfair.

Let me make a brief note on the revenue effects of the various options I have explored, and I am sure that this committee will explore. You will find that virtually any of the possibilities to solve this problem will be expensive—very expensive—at least the ones that make good policy sense.

How a technical correction to the 1984 Act resulted in so much revenue I will never understand. However, in conversations with the Treasury, I have found that it is their consensus that nonconforming banks are not on an accepted method of accounting.

Under Revenue Procedure 84-74, if a taxpayer comes forward asking for relief and to begin an accepted method of accounting, a 3-year spread will be given on the Section 481 income, beginning either in the current year or the following year, depending on the circumstances.

If this is indeed the rule, then I cannot believe that my recommendation to you today would truly result in a substantial revenue loss. It is my feeling that Treasury must issue to you—to this committee—their formal position regarding the treatment of these banks and that a new revenue estimate will be necessary so you can reconsider your options.

Again, it is my recommendation to this committee, and certainly my pleasure to be here in support of the effort and the work that Senator Daschle has undertaken, to consider Section 801 of the Tax

Reform Act to be the overriding intent of Congress on the issue of cash accounting.

If I can be of any assistance to you in this regard, or to members of your staff, please let me know.

Senator **Baucus**. Thank you, Congressman, for that very forceful, eloquent statement relating to the problems of short-term obligations, specifically with small banks. Coming from a State that has many smaller banks, I fully appreciate the problems that you are raising.

Congressman **Daub**. Mr. Chairman, I know of your interest, and I would think that you could certainly request Treasury to simply let us all know whether or not they would give, upon request, that 3-year opportunity to convert to an accepted method of accounting. It might solve a lot of the problems if they would just tell us that they would be willing to do that.

Senator **Baucus**. A very useful suggestion. Senator Matsunaga, any questions?

Senator **Matsunaga**. No questions, except to commend you, Congressman Daub.

Congressman **Daub**. Thank you.

Senator **Matsunaga**. Stick to it.

Congressman **Daub**. Thank you. That has more allegory than illusion. Thank you. (Laughter)

Senator **Baucus**. Thank you, Congressman. Our next witness is Mr. R. J. Vogel, who is the Chief Benefits Director, Department of Veterans' Benefits of the Veterans' Administration, Washington, DC. Mr. Vogel, we are happy to have you here, and why don't you begin in any way you want?

STATEMENT OF R. J. VOGEL, CHIEF BENEFITS DIRECTOR, DEPARTMENT OF VETERANS' BENEFITS, VETERANS' ADMINISTRATION, WASHINGTON, DC

Mr. **Vogel**. Thank you, Mr. Chairman. It is good to be here. I have a brief summary statement, and I ask that that be placed in the record; and I can roll through this with some dispatch.

Senator **Baucus**. Without objection.

Mr. **Vogel**. I am pleased to present the views of the VA on S. 2611. The views I will present are the positions of the Veterans' Administration. The Office of Management and Budget, as Mr. Ross has indicated, have the position under advisement and under development.

We support the enactment of S. 2611 that would allow the Internal Revenue Code of 1986 to authorize the VA to use IRS income information to verify eligibility in certain veterans' benefit programs which are affected by income. We believe the integrity of these programs would be significantly improved if IRS income information from third parties were made available because this would give the agency the opportunity to independently verify the income data provided by a VA program applicant or beneficiary.

I wish to emphasize that we are not requesting access to taxpayers' income returns. We are requesting third party information only, that is, the data submitted to IRS by entities such as employers and banks. This data is currently used by IRS and other agencies for audits similar to those the VA wishes to perform.

On an annual basis, we review the continued eligibility of persons receiving pension benefits and are requiring that they submit an annual report listing all sources and amounts of income. The review determines whether the annual amount of that benefit, which under current law is reduced $1.00 for $1.00 based on income, should be adjusted according to changes in the individual's income.

We already have established regular computer matching of benefits paid by other Federal entities, such as the Social Security Administration and the Office of Personnel Management. These matches and various audits by the VA's Inspector General are helpful in assuring program integrity, but they are not fully adequate for comprehensive determination of other income.

Moreover, not all possibilities for verifying pension income reports have been legally available for exploration. The VA remains unable to monitor effectively and to verify income from private sources such as wages, interest, or retirement benefits.

Two recent GAO reports concluded that Congress should consider amending the Internal Revenue Code to grant VA access to the same earned and unearned income information that the Deficit Reduction Act authorized seven other Federal benefit programs to receive. Those conclusions came from analyzing the detailed quantitative results derived from computer matching of a representative sample of VA records with IRS return information.

The cost effectiveness of such matching was amply supported by the data which revealed that in the first report potential overpayments to veterans could have exceeded $10 million with only a relatively small $65,000 data processing cost.

In the second report, GAO found that with access to tax data, the VA would be able to identify $157 million of potential overpayments. They further estimated that the cost effectiveness of using third party income data to verify income reported by pension beneficiaries to the VA was a favorable ratio of eleven to one.

State and local agencies currently access IRS information for use in verifying eligibility and correct payment amounts for certain federally funded benefits programs. Certainly, the VA, a Federal agency, should be afforded access to IRS return information in order to make such determinations in similar federally funded income-based programs.

Our experience with computer matches of State wage and VA pension benefits information has involved several States and has reinforced our belief that significant cost savings can be accomplished both from recoupment of overpayments, but more importantly probably for cost avoidance.

My complete statement indicates the magnitude of the savings found in just ten States based on matching only wages. The Treasury Department has articulated their concern with respect to voluntary compliance with the tax laws and has disclosed to us some concern about taxpayer privacy.

We don't agree that VA access to tax data would adversely affect voluntary taxpayer compliance. GAO argues that the potential addition of 1.6 million VA pensioners to the more than 80 million recipients of Federal benefit programs, for which access to income data currently exists, should have very little incremental effect on voluntary compliance.

We doubt that there would be 1.6 million participants added. The income information of many of these veteran pensioners is already being reported in food stamps and other DEFRA programs. GAO anticipates that knowledge that income reported by VA pension beneficiaries in the annual self-reporting questionnaire would be subject to verification using third party reported tax data should have a favorable impact on compliance with VA requirements.

The second GAO report squarely addresses the Treasury and IRS policy that alternate sources of income information must be exhausted prior to seeking IRS data. In this regard, the GAO observed that there was no acceptable substitute for independent verification.

The GAO acknowledged that resorting to quarterly wage information from the individual 50 States was impractical, even if all States cooperated and data accuracy was ensured. For example, State wage data excludes earned income from some categories of individuals; moreover, there is no practical source of interest and dividend information.

We concur with the GAO that the IRS policy on requiring exhaustion of alternate sources of income information is neither practical nor efficient.

In conclusion, the VA supports favorable enactment of this timely and important provision. As the foregoing testimony reveals, the bill would provide significant cost savings and reduce fraud and misreporting in VA income based benefits programs.

Thank you, Mr. Chairman. I would be pleased to answer any questions you or the members of the committee may have.

Senator BAUCUS. Thank you, Mr. Vogel. I think it is important not to take the Treasury's concerns lightly. As you well know, we have about a two percent audit rate in this country, and this country very much depends upon voluntary compliance.

I think it is also true that the more tax information is made more available to more Government agencies, the more voluntary compliance is going to suffer. I don't think anyone can really quarrel with the principle.

In fact, our underground economy in America, as you know, is quite large. There are some estimates that it is as high as $100 billion of income taxes owed, due and payable that are not being paid—not being collected. And the concern is that this is going to make it worse.

Let me back up a minute. As you know, to some degree this Congress is moving more towards mean testing various programs. We have a big Federal budget deficit; we are trying to find ways to provide programs, but not provide unnecessary benefits to wealthier people who don't need the benefits. To some degree, Medicare is moving in this direction.

I think that the more the Congress passes legislation that tends to limit benefit payments to upper income Americans, the more the tax collection system is going to be under strain. The question is: Where do we draw the line here? Why should the VA benefits program receive this information? If that is so, why shouldn't virtually any other Government agency arguably claim it has a need for this information?

Mr. VOGEL. There is a conflict in regard to the desire of the IRS to ensure continued compliance with the payment of taxes and the program integrity of the VA program as well as so many others. So, we have been in this discussion with Treasury for about four years. They have been providing data to the other organizations, other Federal entities, for some four years.

It will be interesting to note whether they have found any impediment to voluntary compliance in these four years. I understand a study is under way now, but they have been at this for a period of time. So, it seems to me that they might have some experience base.

Senator BAUCUS. What confidentiality and due process procedures would the VA have in place for, say, a veteran who is claiming that the tax return supplied to the Veterans' Administration is the wrong one and there is a mismatching of returns? I mean, it raises all kinds of questions: first, confidentiality for two different taxpayers; and second, due process, that is the ability of the veteran to challenge whether or not the Veterans' Administration is correct in limiting or denying benefits because of incorrect information supplied by IRS, due to some mismatching or some mistake. And we do know that there have been some mismatches.

Mr. VOGEL. Yes, there certainly have been. What we would do in affording veterans all rights to due process under the law is first of all put a notice out to advise all individuals—a public notice—before we would take any action at all based on information we would receive.

We would give a prospective notice to the beneficiary about what our information is and what we intend to do with it before we would effect a reduction in benefits. They then would have an opportunity to come back in to dispute it, tell us that they believe we have a mismatch on the records—those things do happen, as you know.

So, all due process rights will be afforded them before the VA would take any untoward action in regard to their eligibility for either pension or for a parent DIC case or with respect to individual unemployability in our compensation program.

Senator BAUCUS. Thank you. Senator Matsunaga?

Senator MATSUNAGA. No questions, Mr. Chairman.

Senator BAUCUS. Thank you very much, Mr. Vogel. We appreciate your testimony.

Mr. VOGEL. Thank you, Mr. Chairman.

[The prepared statement of Mr. Vogel appears in the appendix.]

Senator BAUCUS. Our next witness is Congressman Jimmy Hayes. We are glad you are here, Congressman.

Congressman HAYES. Thank you.

Senator BAUCUS. We also appreciate your patience.

STATEMENT OF HON. JIMMY HAYES, A U.S. REPRESENTATIVE FROM LOUISIANA

Congressman HAYES. I am going to put into the record, if there is no objection, the statement by Congressman Tauzin on the legislation on which I wish to testify, Senate 1821. Congressman Tauzin has, in deference to the importance of this committee, taken one of his rare exceptions, and his statement is in English this time, which I am sure the staff will appreciate. (Laughter)

Congressman Tauzin would be here this morning, but the delegation voted not to let him out in public today. Therefore, he has asked me to fill in at this moment.

I had wondered, in doing so, what it was that I was going to tell you in support of S. 1821, and I thought about the late Gillis Long who once made a comment to me that the United States Congress was the best post-graduate school in the world. And by that, what he meant was that you have the opportunity to see perspectives which you had not had the experience or opportunity to view before.

I represent the area of the Louisiana Seventh District, the nine parishes that Congressman John Breaux—now Senator Breaux—formerly represented for 14 years. I was amused in listening to the previous testimony, as erudite as it was and as competent as it was, by Mr. Ross. To put in terms that you would understand, the Treasury view from Washington and the practical experience from those processors in Louisiana are indeed distinctive.

Let me try to put it this way: Mr. Ross would not have made a good cast member in "The Big Easy"; and likewise, those people who process crawfish and catfish and shrimp and seafood in south Louisiana would not be a profile in Fortune 500. They are, in fact, very small mom-and-pop operations, and the people that they contract with are in fact independent by any definition.

In the past, the Treasury has, in its wisdom, determined that they are independent contractors. That is the correct view. Only recently has Treasury reversed itself and taken the position that they are employees in the traditional sense of that term.

The motivations have not been brought about by any change in which the industry operates. It does today what it did 50 years ago. On afternoons in which particular seafood is presently being harvested and shelled, it sends out a call, people arrive, they shop their opportunities for that day.

They sometimes on one day are in one operation; on another day, they are in another. On still another day, they walk out and decide that they are not going to work that day at all. They are not paid a set wage. They determine that themselves with individual negotiations. They are paid in various manners, usually by volume produced. Therefore, they are entirely on their own. They are not under the subject or control of any of those who operate processing plants as employers.

There is also dwelled upon in the statement by Congressman Tauzin the economic condition of south Louisiana. I suggest to you that, while that is correct, that we are devastated with a current real unemployment rate of above 30 percent, you should not legislate in any area of tax law based upon needs within a community.

But let me suggest to you that, because of the tremendous shortage of revenue in Louisiana, the fact that our State statute is not so far from what had been the previous interpretation of the Treasury, the fact that the state of Louisiana, that has tremendous revenue needs and is currently running a deficit of around $700 million, has not chosen to treat these individuals as employees under State law, should lead the Treasury to the same conclusion.

The State of Louisiana has certainly the most motivation to enhance its revenue, enhance its tax base; and therefore, if it felt that this were not a correct reflection of the industry, it would have taken a different action many years ago and certainly by now.

Second, because there are almost 500 of these seafood operations throughout the State of Louisiana, because of economic deprivation as exists today, please don't prove that the industry is right by having it lose its source of contract employment and therefore go out of business.

If the call is close, since Treasury made the determination before and is in fact reversing itself, if the committee feels that it is an area which merits further inquiry, then do so. But please don't take the rigid position of determining that these are employees and let them come back next year or the year after to try to tell you that consequently these operations have been shut down.

Louisiana simply can't afford that. And I would ask your indulgence in my support of S. 1821 to simply recognize that the people who understand and use the phrase, "l'espalles du potats," do not understand Treasury regulations; and I respectfully submit to you Treasury doesn't understand them. Thank you very much, and I will leave congressman Tauzin's statement.

[The prepared statement of Congressman Tauzin appears in the appendix.]

Senator BAUCUS. Thank you very much, Congressman Hayes. Any questions for the Congressman? (No response)

Our next panel consists of Mr. Frank Swain, Chief Counsel for Advocacy of the Small Business Administration; Joseph Cordes, Ph.D., Professor of Economics and Associate Dean for Faculty Affairs, George Washington University; and Martin Baily, Ph.D., Senior Fellow, The Brookings Institution and Consultant, Council on Research and Technology.

We also have the statement of Senator Armstrong which he wishes to have placed in the record. Mr. Swain, welcome, and why don't you begin? I commend you on your efforts, too, on behalf of the R&D tax credit.

STATEMENT OF FRANK S. SWAIN, CHIEF COUNCIL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC

Mr. SWAIN. Thank you very much, Mr. Chairman and members of the Subcommittee. Although there are a number of issues on the Subcommittee's docket this morning that seem to relate to small business, my purpose here is to discuss the research and experimentation tax credit and specifically the bill that you and Senator Danforth have introduced, S. 2484.

It is appropriate that small business is represented here today because small business is a very efficient and effective producer of innovation. Studies that we have done, that are attached in detail to our statement, indicate that small firms innovate at a rate twice that of large firms per employee and are spending twice the percentage of their research budget on basic as opposed to applied research.

Despite this, the design of our current credit structure has prevented small business from fully utilizing the credit or receiving an equitable share of its benefits. Moreover, the credit has been completely denied to startup firms in their efforts to develop innovative products.

I strongly support the enactment of a permanent research and experimentation tax credit to replace the current credit. However, I believe that the credit must be restructured to achieve its essential purpose; and S. 2484 would, in our opinion, achieve that needed change in the credit structure, substantially approving its effectiveness.

I might also add that, in addition to the very fine work done by your office and Senator Danforth's office, a number of agencies within the Administration—not only the Small Business Administration, but the Department of Commerce, the National Science Foundation, and of course the Treasury Department—have worked very hard with the private sector, both large and small business and academic institutions, to try to work out an improved approach to the credit.

The current R&E credit applies to the increase of the present year's qualified expenses over a base; and of course, Mr. Ross described and articulated very well the details of the current credit and how your proposal differs.

An important limitation on the current credit is that it applies only to those expenditures incurred in carrying on an existing trade or business. S. 2484 for the first time makes the credit available to new firms or firms expanding into new trades or businesses which intend to use the research in the active conduct of a future trade or business, effectively removing any carrying on distinction.

Mr. Chairman, there are a number of very important innovations in our society, including magnetic resonance imaging, six-axis robot arm, and others, that would not have qualified for the current credit as it is presently structured.

Equally important, the legislation would eliminate features that have prevented established businesses from fully utilizing the credit. Because the credit is tied to a firm's previous year's expenditures, the expenditures by the firm in one year have served to block the availability of the credit in future years. And so, firms have sometimes been artificially stimulated to postpone expenditures.

The fixed base provides a constant, smooth transition for firms of all sizes. We have done some specific analysis, which is attached to our statement.

Mr. Chairman, to try to summarize our position, if national public policy is to encourage broad and effective innovation—and I believe that is responsible public policy—then the appropriate stimulus should be available to all sectors of the innovating community.

Second, small business is extraordinarily innovative; but for reasons of size and skill, they are many times not able to capture the financial results of that innovation. So, stimulus to them is particularly important.

Third, for other reasons, the structure the current credit just doesn't work for small business. It needs to be changed. It doesn't simply need to be extended; it needs to be changed and extended. The structure proposed in your bill, S. 2484, solves the essential problems for both the startup firms and the slow growth firm.

Your bill is widely supported, and we endorse it as well. I will be happy to reply to any questions.

[The prepared statement of Mr. Swain appears in the appendix.]

Senator BAUCUS. Thank you, Mr. Swain. Dr. Cordes?

STATEMENT OF JOSEPH J. CORDES, PH.D., PROFESSOR OF ECONOMICS AND ASSOCIATE DEAN FOR FACULTY AFFAIRS, GEORGE WASHINGTON UNIVERSITY, WASHINGTON, DC

Dr. CORDES. Thank you. I am pleased to have the opportunity to offer my observations on Senate bill 2484. In the time allotted, I shall comment about two distinct policy questions that should be posed in evaluating the desirability of the proposed legislation.

First, should an additional financial incentive for the conduct of private R&D become a permanent element of U.S. science and technology policy?

Though I am basically sympathetic to the idea, my response for a number of reasons has to be somewhat equivocal. The problem here is not with being able to make a very reasonable theoretical case that, in the absence of some public support, markets will fail to allocate sufficient resources to R&D.

So long as the gains to society from certain kinds of private R&D cannot be captured fully by the firm performing it, the financial incentives to undertake such activities will be weaker than it should be, creating the possibility that potentially valuable social benefits will be unexploited.

However, while economic theory suggests that such market failures are a distinct possibility, economic research to date provides relatively little information on how serious such market failures are in practice. For example, we know that after the fact the social returns attributable to certain kinds of projects have exceeded the returns to the firm conducting the R&D. Yet such estimates are available precisely because the R&D was undertaken in the first place. Put another way, while the social returns to R&D may exceed the private returns, the private returns may nevertheless be handsome enough to provide an adequate incentive for the R&D to be undertaken.

Perhaps more to the point, even if one concedes that market failures are serious in practice, the desirability of enacting a permanent financial incentive should most properly be evaluated in the context of other public policies for supporting R&D. For example, incentives to conduct R&D can also be improved by increasing the ability of firms to capture the economic fruits of their efforts through improved protection of intellectual and technological property rights. Alternatively, ways might be found to encourage firms to cooperate in conducting research with high spill over benefits as, for example, has recently been done through the National Cooperative Research Act of 1984.

I would like to emphasize that concerns of this sort do not necessarily mean that one should refrain from providing additional financial incentives in the form of a permanent R&D credit. However, especially in an era of Federal budget austerity, it certainly seems appropriate to raise questions about the use of scarce fiscal resources, even for a laudable social purpose such as encouraging R&D.

For these reasons, while I recognize fully the advantages of making the credit permanent, one might at least wish to consider a temporary extension of the credit, though certainly for more than a 2-year period of time, perhaps something more along the lines of 5 years.

Alternatively, if one indeed is committed to making the credit permanent, one might consider enacting a somewhat less generous credit than the one currently proposed in S. 2484, perhaps very much along the lines suggested by Mr. Ross in his testimony.

The second issue raised by the bill is that, if a financial subsidy were to be provided to R&D, is an R&D tax credit of the sort proposed the best vehicle for doing so? Here, my response is considerably less equivocal.

First, since private entrepreneurs and managers will almost invariably be better able than civil servants to make the numerous complicated scientific and technical judgments needed to transform a good idea into a commercially viable product, tax credits which minimize the degree of direct Government involvement have certain advantages as compared to more direct Government grants.

Second, partly through the efforts of this committee, the Tax Reform Act of 1986 has already significantly improved the design of the credit by tightening the definition of eligible R&D. While this change does not guarantee that all R&D spending which qualifies for the credit will generate spill over benefits, it certainly raises the likelihood that such will be the case.

Finally, the changes proposed in S. 2484 and the general structure of the credit will dramatically enhance its incentive effects. Indeed, regardless of one's views on the desirability of enacting a more permanent incentive for R&D, the changes proposed, especially those involving the definition of the credit's base, would clearly make any credit that were put into place a more effective instrument of U.S. science and technology policy than the current credit. Thank you.

[The prepared statement of Dr. Cordes appears in the appendix.]

Senator Baucus. Thank you, Dr. Cordes. Dr. Baily?

STATEMENT OF MARTIN N. BAILY, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION, AND CONSULTANT, COUNCIL ON RESEARCH TECHNOLOGY, WASHINGTON, DC

Dr. Baily. Thank you. I am delighted to be here. I do have a written statement that I would like in the record.

I think we have a neat proposal here; I really do.

Senator Baucus. Excuse me. We have a what?

Dr Bailey. Sorry to use that word; a neat proposal.

Senator Baucus. Oh, all right.

Dr. Baily. I think this is a really good proposal. (Laughter)

Senator **Baucus**. Nothing wrong with that.

Dr. **Baily**. I want to make that clear. It is familiar ground, but I do want to stress—perhaps even more than Joe Cordes did—that when a CEO is setting his R&D budget and he sets it on the basis of what he in his or her own firm can get out of the R&D, it is not going to be enough. Not enough R&D is going to be done, and taxpayers do have a legitimate interest in trying to add to the amounts.

I think there is a very important difference between this credit and other credits that are being proposed. There is a clear case for an R&D tax credit. Let's look at the existing credit.

There is controversial evidence on this, but I think the weight of the evidence is very clear, the credit has been an effective tool of public policy. Robert Lawrence and I have looked at this and have found that it had a substantial effect.

Other people, including Professor Cordes himself—although he sometimes tries to run away from his own numbers—even he has found it to be a strongly effective credit. He reports in a written statement that he is going to introduce into the record that R&D took off really, much more than he had projected, right at the time when the credit was in force.

So, I think the weight of the evidence—not all the evidence, but certainly the weight of the evidence—is that this has been a very effective credit. The existing credit clearly does have a problem. It provides only a rather small incentive; it can in certain cases actually provide a negative incentive.

A second problem the existing credit has is that some of the firms are dropping out; they are simply just not eligible any more. We have companies that have come on hard times, been very pressed perhaps by foreign competition.

They would like to expand their R&D, but they have not been able to do so; and they are going to sort of fall out of the reckoning. They say there is no way they can, at least over the next few years, get any credit from this thing. Our current R&D is too low; we are going to be below the base.

What this new proposal does that I think really makes it worthwhile is it raises the incentive. For a company with a primary credit, it provides a very substantial incentive. It does so at a very low budgetary cost. It is not providing a lot of money; it is providing money for the most part only for projects that are add-ons.

If you are weighing up an additional project, you can get a very substantial benefit from the credit.

The second part of the new proposal is the seven percent; and I think that is designed to broaden the base. We have to have an increase in R&D in the Rust Belt as well as in Silicon Valley; and I think there are companies there that can be encouraged, not at the same rate. We can't give them the same incentive, but we can under this proposal give them some incentive.

So, I am excited about this. I think it could potentially make a big difference. It provides a much bigger incentive and is much better designed.

Let me stress, therefore, that I would like the Senate to resist attempts, particularly resist the Ways and Means Committee proposal, which is going to cut the existing credit back almost to nothing. If the Ways and Means proposal goes through, we really are not going to have a credit worth anything. It is going to be there, but it is not going to provide much of an incentive.

I think it is really important that we resist that.

Second, I hope we maintain the size of the incentives that are in this Baucus/Danforth proposal and don't let them be chipped away and chipped away. We are not doing a whole heck of a lot to support growth and productivity in this country. I think we should be doing a little bit more than we are. I will stop there, Mr. Chairman.

[The prepared statement of Dr. Baily appears in the appendix.]

Senator BAUCUS. Thank you very much.

I appreciate the testimony of all of you and agree with all of you that the new bill introduced by Senator Danforth and myself is an improvement over current law insofar as it addresses the problems of startups, whether it is a new company or starting up a new line of business.

It also addresses the problems of small business, which is a very real problem in America. In fact, I think someone once said—and I have never heard it disputed—that 80 percent of the new ideas and innovations in America come from small business; you know, they don't come from new business.

Certainly, if that is the case, there is a strong argument for helping small business. I think the seven percent alternative is good for slower growth companies; it is no doubt an improvement.

Let me ask you some questions that we have heard in opposition to this. One is that businesses that spend money in R&D are going to do so, anyway; you know, they don't need a credit. Under current law, what is your answer to that question? Any of you?

Then, I am going to ask the same question with respect to S. 2484.

Dr. BAILY. It does provide some incentive. Under the original design of the credit really was, when it was first enacted, it was thought that it would provide a 20 percent incentive. This turned out not to be the case because of the rolling base provision.

The rolling base doesn't completely eliminate the incentive; it is still an incremental credit. I just think the new proposal would do a much better job at encouraging the additional projects and not giving more than a small amount of encouragement for the stuff that is already being done.

Dr. CORDES. If I can just add to that? Certainly, if the comparison is either between current law or the modification of current law that I understand has been tentatively agreed to in the Ways and Means Committee and this bill, I really don't think there is a serious contest.

I think that this bill, along with the changes that this committee had some role in enacting in the eligibility rules for the credit in 1986, really now make this about as reasonable an incentive as human beings, given imperfect information about what firms are doing, can design.

And I think looking at how firms respond to this credit, quite frankly, would be a much fairer test of whether something like this can work well than what we have seen. I just think what is in place now is flawed in so many respects that, while we have learned something about how firms have responded to a credit, it is really not a very good one. And this would be a much fairer test.

Senator **Baucus**. Is it fair to say the gain those persons who undertake the additional R&D expenditures because of S. 2484 outweighs the so-called cost involved because other firms would be making the expenditure, anyway? Is that a fair statement?

Mr. **Swain**. I would like to observe, Mr. Chairman, that the gain is primarily going to be, it seems to me, among firms that cannot take the credit at all now, that will take some credit under the revision. And at least as far as small firms are concerned, the cash flow and the projections are usually exceedingly thin; and any assistance, even though it is fairly modest, may have a significant stimulative effect.

It seems to me—and I have read some papers by both of the other witnesses—that the absolute answer to how much R&D you buy with a foregone revenue dollar is a little bit mixed; but everybody is in agreement that you are going to buy more with the revised proposal than you would with existing law.

Dr. **Baily**. This proposal, I think, is much more geared to public policy. It will not give money to the firms. I mean, the companies are not going to get much more money than they are getting now, but the public policy incentive, I think, is much greater.

Senator **Baucus**. When we go to conference, we are probably going to face these choices. One is to agree with the House version thus far and a 2-year extension and change in the deduction. And the question might arise as to whether we would agree to a shorter extension of the time period for the credit but with the changes of S. 2484. That might be one option.

Another option might be for a longer period—if not permanent, for a longer period—but, perhaps not at this point, the changes of S. 2484. I am curious as to which of the various options we may face you think are more important. That is, if you prioritize them in some way in order to give us some advice and guidance as to how you think this committee should proceed.

Dr. **Baily**. You are sort of "between the devil and the deep blue sea." I think there is a lot to be said for making it permanent because of the reasons that were given. It is a long-term decision to invest in R&D.

On the other hand, on the whole, I would say that the improvement you are going to get out of your bill is so much greater, that is probably the first thing to fight for.

Senator **Baucus**. Don't misunderstand me. I am very strongly a proponent of Senator Danforth's bill. I think it should be permanent, and I think the provisions of S. 2484 should be in there, with respect to the startups and the alternative of moving to a fixed base and also the primary alternative credit.

But we may very well find ourselves in a situation where we have to make some choices.

Dr. **Cordes**. If, for example, the choice were between making the existing credit permanent, perhaps as modified by the Ways and Means Committee, or enacting a temporary version of Senate bill 2484, although for more than two years—I think one would want to think more in terms of a three, four, or maybe even a 5-year extension.

The structural improvements in S. 2484 are so significant, I think, that in my own mind it would be worth trading off those for the permanence, such as it is, of a credit that in its current form is quite seriously flawed.

So, that is one kind of trade-off that I professionally would recommend considering.

Dr. **Baily**. I agree.

Mr. **Swain**. I would agree with that, too, Senator.

Senator **Baucus**. Thank you. Senator Danforth?

Senator **Danforth**. Especially since you are for permanence, anyhow.

Dr. **Cordes**. I am agnostic about it at the moment.

Senator **Danforth**. Let me ask some questions of you, Dr. Baily. First, on the R&D credit that now exists that was first enacted in 1981, has that been an effective stimulus to research? Has that worked?

Dr. **Baily**. In my view, it has. I think when you line up a lot of economists, you are going to get different results; not all economists agree on that; but I think my reading of the evidence presented to this committee on that matter suggests that it has been effective.

And as I mentioned, the study by Jane Gravelle at CRS, the study by Kenneth Brown, even Joe Cordes' own study, suggest that it has been effective. So, I think the weight of the evidence is that it has been effective.

Senator **Danforth**. Can you quantify that? I don't have those studies in front of me; but how would you quantify the effectiveness of the existing credit?

Dr. **Baily**. We found in our own empirical analysis that the credit was getting dollar for dollar; in other words, for a dollar of lost revenue, it was adding about a dollar to R&D spending. I think some of the other studies have found it to be a little bit less than that. So, it is around that range—dollar for dollar or a little less.

Senator **Danforth**. So, therefore, how much has it added to R&D spending? Do you know?

Dr. **Baily**. Over the period, we estimated that at about $2.5 billion.

Senator **Danforth**. $2.5 billion?

Dr. **Baily**. A year.

Senator **Danforth**. A year? And what percentage increase would that be in R&D?

Dr. **Baily**. That was a 7-percent increase.

Senator **Danforth**. A 7-percent increase over what R&D spending would otherwise have been?

Dr. **Baily**. Yes.

Senator **Danforth**. Is that about right, Dr. Cordes?

Dr. **Cordes**. I just fall into that group that gives a more modest set of estimates. What I have looked at, let me emphasize, is the 1981 credit because we really don't have—

Senator **Danforth**. Sure. That is what I am asking about.

Dr. **Cordes**. If I remember my own numbers correctly, I would put the gain in R&D per dollar of revenue loss probably more in the range of maybe 50 to 60 cents, rather than a dollar, which would probably give one about a two to three percent increase instead of four, which means it has had an effect.

Senator **Danforth**. And Dr. Baily said seven percent.

Dr. **Cordes**. Yes. I would say three to four.

Senator **Danforth**. Three and a half to four. Now, let me ask you this. The Treasury believes that this new version of the credit, as modified by the Treasury's revenue-neutral suggestions, would be about six times as effective. Would that be about right?

Dr. **Baily**. The incentive effect would be six times.

Dr. **Cordes**. Yes, I would agree with that. In fact, in my prepared statement, I point out that, given other research that I am familiar with that was supported by the NSF—which looked at similar kinds of structural reforms of the credit—it is certainly quite plausible that with the restructuring one could get a credit which stimulated R&D by more than a dollar for every dollar of revenue lost. So, it would definitely enhance the stimulative effect.

Senator **Danforth**. So, you would say at least twice as effective; Treasury would say about six times as effective. What would you say, Dr. Baily?

Dr. **Baily**. I think the incentive is six times as effective. To make the step then from how large the change is going to be and behavior of companies is a large step. I think we would get substantially greater R&D out of this new proposal than out of the existing one. Without knowing, without being able to see what happens, it is a little bit hard to put a number on that; but I wouldn't be surprised to see it two or three times as large an effect.

Senator **Danforth**. Two or three times as large an effect? What does that mean? Does that mean per dollars spent, that instead of getting a dollar back in research, you would be getting two or three times—two or three dollars?

Dr. **Baily**. Yes.

Senator **Danforth**. Can you explain to us how the present system, any of you, can have a perverse effect under certain circumstances on research?

Dr. **Baily**. If you are a company that is going to cut its R&D in any case, perhaps a small company has finished a project and is planning to start a new one—maybe it has some other smaller projects around. Under the current law, if it cuts back on its R&D, it will cut back on its base; and that will give it a larger credit in the future when its R&D starts to rise again.

I don't think this is a particularly important case empirically. But in principle, a small company that cycles could be better off by cutting its R&D today, cutting its base, and getting a bigger credit in the future.

Dr. **Cordes**. If I may briefly amplify. The perversity, if you want to call it that—and I think it is not a desirable incentive—has more to do with the timing of when the R&D is done than necessarily with whether it is done or not. The type of behavior that Martin has just talked about would probably involve a company deferring the startup of a project until, say, the subsequent year when it might make it more eligible for the credit.

That wouldn't change the overall amount of R&D that the company does over a period of time, but it would affect when it does it.

And it is not clear that there is any social purpose to be served by that.

Senator **Danforth**. Let me just put this in the vernacular, going back to the other question. I mean, the vernacular is "bang for the buck." It is a phrase that we always use in the Finance Committee.

The Treasury's view is, as I understand it, that we would get about six times more bang for the buck under the new credit than under the old one. Your view, Dr. Baily, is that it would be about three times the bang for the buck?

Dr. **Baily**. Yes.

Dr. **Cordes**. I wouldn't have any serious disagreement with that. Three times, yes.

Senator **Danforth**. Do you have an opinion, Mr. Swain?

Mr. **Swain**. I don't have a numerical opinion, but I think it is important for the committee to realize that you get bang for the buck in two ways. You would get it by extending it to other firms that haven't taken it at all, and you get it by offering it to some low growth firms that aren't able to take very much of it now. So, you get a broader bang for the buck.

Senator **Danforth**. And your view is that this new version is more helpful to small business because why?

Mr. **Swain**. It is more helpful to small business for two reasons. Number one, the existing credit, because of the "in carrying on" clause, is not applicable, in most cases, to startup firms.

Second, it is not applicable in many cases to new firms or low growth firms where the amount of R&D spending is low or highly cyclical because of the moving base, which Professor Baily just discussed.

So, your proposal solves both of those problems; and frankly, I think that both of those problems have to be solved in order for the legislation to be good public policy.

Senator **Danforth**. Thank you all very much.

Senator **Baucus**. Thank you. Senator Matsunaga?

Senator **Matsunaga**. Thank you, Mr. Chairman. When I was in law school in Cambridge, I was told by a professor on taxation that the Tax Code should be used to engineer social objectives. Do each of you agree with that or not?

Dr. **Baily**. On a very limited scale. I think we are gun shy about doing that. A lot of things that were in principle set up for social engineering purposes turned out to be perhaps special interests that eroded the tax base. I think we got into trouble, and I think tax reform was a reflection of the fact that we got into trouble.

But to say that doesn't mean we should eliminate all efforts to improve the efficiency of the economy through the Tax Code, and I think we have seen the R&D tax credits survive through a period of tax reform, through a period of budget difficulties; and I think it has survived for a reason. It has a very sound basis for its existence.

Senator **Matsunaga**. Dr. Cordes?

Dr. **Cordes**. Yes. The traditional criticism, of course, is that in theory you should be able to accomplish the same objective by means of a direct grant program that you could through tax incentives. The problem I have with that position, if it is taken too literally, is that you are making certain assumptions about the ability, for example, of Government agencies to do the same kinds of things that private decision makers can do.

I think in some cases that is quite correct; and in those cases, you really ought to steer clear of using the Tax Code.

The case of R&D is somewhat a different case because, as R&D managers will tell you, the issue is not just figuring out what is the state of the art technically or from an engineering perspective.

That is only part of the process. The other part is also trying to determine what makes commercial sense, and that is a very complicated kind of problem. And I think that is the kind of decision that private managers are probably better equipped to make than members of Government agencies.

So, I think you have to be careful what kinds of alternate grant programs you are setting up, whether they are too idealized relative to what the real world is like.

Senator MATSUNAGA. Mr. Swain?

Mr. SWAIN. I would make two brief comments, Senator. First of all, the process of research and innovation is, in effect, betting on the future. And I think smaller firms with thinner balance sheets always find that a little bit more difficult decision to make than larger firms which know they are going to be around in the future.

So, it is appropriate, I think, for the tax system to stimulate that sort of conduct.

Second, regardless of what I suppose tax policy theoreticians might hold on your particular question, the fact is that the United States is in a worldwide competition for innovation and research, not because we are necessarily bad researchers or innovators, but because a lot of other people in the world have gotten a lot better very quickly.

And we have to be cognizant that we are dealing in an international economy in which some other governments have much more aggressive governmental stimuli for innovation than we do.

Senator MATSUNAGA. Generally, of course, you agree in the case of R&D that incentives ought to be provided, and such incentives should be by way of tax credit?

Mr. SWAIN. Very much so, rather than a direct grant approach.

Senator MATSUNAGA. Would this extend into the area of the development of alternative energy?

Dr. BAILY. I believe there is the scope for a direct Government program in certain areas. Certainly, the National Science Foundation has a tremendous history in basic science, and I think there are cases where the Government may have to get directly into the task of major technology development, where individual firms simply don't have the resources or are unwilling to bear the risk.

Again, we have gotten into trouble in some of those, too. I think they have to be viewed cautiously.

Senator MATSUNAGA. But as I understand it, S. 2484, as revised, would include alternative energy; is that your view? Dr. Baily?

Dr. BAILY. Yes, I believe so.

Senator MATSUNAGA. Yes. Dr. Cordes?

Dr. CORDES. As far as I understand the eligibility rules that were put in effect in 1986, which I believe are simply restated in this bill, certainly new sources of energy would come under that umbrella.

Senator **Matsunaga**. Mr. Swain?

Mr. **Swain**. Yes. I think it all depends on the eligibility rules, which are already in effect.

Senator **Matsunaga**. Thank you very much.

Senator **Baucus**. I was wondering, gentlemen, do any of you know the degree to which other countries give a greater R&D incentive to business? I mean, we are getting more and more into international competition; and I think it is important, to the degree that we can, to analyze this question—S. 2484 and the credit—not only within the confines of the United States of America, but as it is related to R&D incentives that other countries give to our competitors.

Do any of you have any idea, can you quantify in any way, or can you give a summary sketch of the degree to which some other country or countries give greater incentives than we Americans do?

Dr. **Baily**. I have looked at those figures, and I would request if I could give you a written answer to that because I can't recall the numbers.

Senator **Baucus**. Sure.

Dr. **Baily**. That is certainly the case in Japan and Canada and Germany and other countries; they do provide important R&D incentives, but I would ask if I could let you have a written response.

[The information appears in the appendix.]

Senator **Baucus**. Do you know whether they are equal to, greater than, or less than American?

Dr. **Baily**. I think it varies. Certainly, some of them are greater than ours.

Dr. **Cordes**. I think I can give you some answer to that, having done some work for the National Science Foundation about three years ago on the comparative tax treatment of innovative activities, at least in the U.S., Japan, and West Germany.

At that time—and this was, of course, before the advent of the Tax Reform Act—it certainly was the case that our R&D credit was probably more generous, certainly more generous than what the Germans were making available at that time. Now, I would need to check to see if they have modified that.

And depending on other assumptions you made about the Japanese tax system, it either was more generous, as well as what they were doing at that time because keep in mind the key feature of the Japanese R&D credit—at least then—was that they had a one-year moving base, which of course dilutes the incentive effect even more.

What happened in the Tax Reform Act of 1986, of course, is that the incentive effect of our credit was scaled back somewhat; and that certainly now puts us in a situation where, unless the Japanese have changed their credit, our current incentive is either about as good as theirs or perhaps a little weaker.

Certainly, Senate bill 2484, however, would probably give us one of the best R&D tax credits that I am aware of that exists currently among the industrialized countries. So, I mean, in that sense it would clearly improve our position relative to where we are.

Mr. **Swain**. Senator, we have some information. It appears that S. 2484 contemplates a structure not dissimilar to the current Japanese structure in which there is a general incremental tax credit, but an alternative flat tax credit available to smaller companies.

Of course, in Japan, there is also to my understanding a seven percent credit on the acquisition or manufacturing costs of high technology machinery. Now, what the total cost of all those credits is, I couldn't tell you; but there is some indication that the Japanese have a flexible system recognizing that different types and sized companies behave in different ways from a research perspective.

Senator BAUCUS. I think increasingly we are all going to have to try to answer that question better than we all can right now. We are going to have to know what the competition is in order to know what we should do ourselves.

The Japanese also have an administrative nature of tax credit; that is, it is tailored more to various industries, and it is done also not only by statute but by administrative action. The Ministry of Finance can administratively tailor tax credits in a way to target the availability of the credit where it seems to make the most sense.

To me, that raises another question. There are some commentators in our country who feel that the R&D tax credit is a little too general, and we Americans should be focusing a little more on developing process technologies and commercialization technologies comparatively more than some other R&D efforts.

I wondered if briefly any of you have a response to that?

Dr. BAILY. I think we have had a disadvantage in our economy because we have not had the same mix between process and products technology. Japan has been more successful in process technology than we have.

They have often been able to borrow our product technology; it is not so easy for us to borrow their process technology. We oppose, however, any specific provision which says this kind of research gets credit and another kind does not. I think it should be as broad as it can be, given the general guidelines of the credit. So, I think it would be a mistake to try and allocate them.

Dr. CORDES. I would have to say, given what we know about R&D among private firms and given our ability to legislate in tax regulations, I think that the changes that were put in place in 1986 are probably about as far as one can go in stipulating that the credit be applied to some activities and not others.

Given my view that I think ultimately it is the managers that have the best information about what makes commercial sense and not just technological sense, I think giving them quite a bit of latitude within some reasonably well-defined guidelines makes the most sense.

So, I would have to agree with Martin. I don't think it would be a good idea to try to limit it to particular activities. Senator Baucus. My time is up. Senator Chafee?

Senator CHAFEE. No questions, Mr. Chairman.

Senator BAUCUS. Thank you all very much. You have been very helpful and very informative, and we very much appreciate the time you have taken.

Our next panel consists of Ann Moss, Director of the Women's Pension Project, Pension Rights Center in Washington, DC; Mr.

David Wray, President of the Profit Sharing Council of America in Chicago; and Mr. Michael Keeling, General Counsel, Employee Stock Ownership Association, Washington, DC.

Is Mr. Wray here? (No response)

I am told he is in the other body in the Ways and Means Committee testifying; he will be over later. Ms. Moss is also at the Ways and Means Committee. Well, Mr. Keeling, it is all yours.

STATEMENT OF J. MICHAEL KEELING, GENERAL COUNSEL, EMPLOYEE STOCK OWNERSHIP ASSOCIATION, WASHINGTON, DC

Mr. KEELING. My name is Michael Keeling, and I am the General Counsel of the ESOP Association. Since the Treasury Department did not endorse the basic thrust of S. 2078, since we are the only private sector witness appearing to testify on this legislation, and we would testify in opposition, since I have submitted my statement that I am sure you have all reviewed, and since the hour is running late, I am perfectly willing to just accept questions and, in essence, allow us to proceed quickly because I know there are other witnesses that need to appear before you, instead of taking five minutes of your time.

Senator BAUCUS. That is a good suggestion. Senator Matsunaga or Senator Chafee, do you have any questions?

Senator CHAFEE. I do not, Mr. Chairman.

Senator MATSUNAGA. I would like to hear a brief summary of the statement.

Mr. KEELING. All right. In the written testimony, we set forth six reasons why we do oppose S. 2078. The essence of that legislation is to require an employee vote prior to the establishment of an employee stock ownership plan.

Our number one reason is that ESOPs are part of the law known as ERISA. This is part of our voluntary retirement system. It is funded by voluntary employer contributions.

If you impose this requirement on ESOPs, that would make the ESOP uniquely different from other plans which can be invested in employer security, such as the profit sharing, the stock bonus, thrift and savings plans. And I think if you looked at the implications of that, you would see that the employer would voluntarily be more likely to establish one of those other plans, instead of the ESOP.

Second, our ERISA laws, which Congress enacted in 1974, place the basic responsibility as to what is in the best interest of the plan participants on the ESOP fiduciary. One would have to assume that, if you have an employee vote prior to the establishment, you are somehow or another going to absolve the plan fiduciary of the responsibility of negotiating and doing things in the best interest of the plan participants.

Third, and I think this goes to the heart of the debate that we could get into about this legislation, under current law there is only one time that the Federal laws require an employee vote; and that is when a certain number of employees are interested in establishing a collective bargaining unit. This is governed under our National Labor Relations Act.

That Act has spawned an untold number of controversies, things such as: when is the election conducted, how long is the election period open, what kinds of statements can be made by management and by employees during the election process, who counts the votes in the election process, who certifies the election?

I looked at one treatise on NLRB cases, and there were 525 cases—major court cases—that have arisen out of disputes during the election period. The Federal Government, I think, has rightfully decided that the employees vote in terms of establishing the bargaining unit and that the bargaining unit elects representatives to negotiate for them; and this bill would kind of turn that on its head.

Fourth, ESOPs are now established in a congenial environment in terms of the vast majority of closely held companies that have 100 to 1,000 employees, where no benefits are given up, no wage concessions are made. There are statistics to show this.

Fifth, there is a possibility that where you have the kind of company, described above this kind of legislation would lead to having these companies register under our securities law, which is an expensive proposition.

Sixth—and this is the sixth reason we would oppose the legislation—we see more and more large corporations committing to an employee ownership plan through an ESOP. I think where you see these large transactions, even though they are still the minority and not the rule, timing is of the essence in allowing the ESOP to acquire the financing to close the transaction.

These are the kinds of companies that typically have bargaining units already established; in other words, they have union representation. This legislation would erode the power of the agents of those unions to negotiate on behalf of their employees.

Those are in essence the six reasons, and I did take your five minutes; but I appreciated the opportunity to summarize those six reasons.

Senator BAUCUS. Mr. Keeling, thank you very much. I agree with the thrust of the your statement. I think it would be a bit far-reaching at this point to try to appropriate the provisions that are suggested in the bill that is before this committee.

In addition, as you pointed out, the Administration is opposed to that same bill; and I think you made a very good statement. Senator Matsunaga, do you have any questions?

Senator MATSUNAGA. No. I just wish to commend you, Mr. Keeling. I think you gave a very concise but comprehensive statement, giving your reasons for opposing S. 2078.

As you probably know, I am a staunch supporter of ESOPs; and I would certainly hate to deter its growth in our nation because I think that is really the solution to management/labor problems.

Senator BAUCUS. Senator Daschle?

Senator DASCHLE. No questions, Mr. Chairman.

Senator BAUCUS. Thank you very much, Mr. Keeling. We appreciate your statement.

Mr. KEELING. Thank you.

[The prepared statement of Mr. Keeling appears in the appendix.]

Senator **Baucus**. We will now turn to the final panel of Mr. Charles Seaman, President of the First State Bank of Warner in Warner, SD; Mr. Gerald James, Vice Chairman of the Lummi Indian Business Council of Bellingham, WA; Ms. Suzan Shown Harjo,Executive Director of the National Congress of American Indians; Mr. Lee Callais, President of Sun Seafood Products, Ltd. and Secretary/Treasurer of the Louisiana Association of Crab Processors, Golden Meadow, LA. Senator Daschle.

OPENING STATEMENT OF HON. TOM DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA

Senator **Daschle**. I have a statement that I would like to insert in the record with your approval.

Senator **Baucus**. Without objection.

Senator **Daschle**. As the panel is coming before the committee, let me just very briefly touch on the purpose of this statement. It addresses the question that we have had on a couple of occasions before the committee since I have been here, and that is cash accounting and accrual accounting for those taxpayers with average annual gross receipts of less than $5 million.

The Tax Reform Act of 1986 allowed those who had gross receipts of less than $5 million to maintain their cash accounting method, but there was another provision of the 1986 bill that I know the chairman is very familiar with, which required that interest income from short-term obligations be accrued; not only that, but that be done on a retroactive basis back to September 27, 1985. This has had a profound effect on rural banks.

Many banks in South Dakota and the upper Midwest, which are having a great deal of difficulty anyway because of the drought, are now even more troubled as a result of this requirement.

So, my bill very simply allows rural banks with average annual gross receipts of less than $5 million to be exempted, like every other cash basis business that size, from accruing interest on short term loans. I have perhaps one of the most authoritative of all of our bankers on this issue before us today, and I am delighted that he has taken some time to come from South Dakota to share his thoughts on the issue with us.

Senator **Baucus**. Thank you. Mr. Seaman, with that introduction, why don't you begin?

STATEMENT OF CHARLES SEAMAN, PRESIDENT, FIRST STATE BANK OF WARNER, WARNER, SD

Mr. **Seaman**. Mr. Chairman and members of the subcommittee, I appreciate the opportunity this morning to testify in strong support of S. 1239, which was introduced by Senators Daschle, Armstrong, and Durenberger. My statement today has the strong support of the American Bankers Association and the commercial banks across the country that the ABA represents.

S. 1239 will provide that short-term loans extended by small cash basis banks in the normal course of business are not subject to the mandatory accrual requirement imposed on other short-term obligations by Section 1281 of the Code.

The First State Bank of Warner finances the credit needs of farmers and small farm-oriented businesses. Sixty to sixty-five percent of our loan portfolio are loans made directly to farmers. Operating loans are made in the spring of the year for planting expenses. Then, another flurry of seasonal activity to farmers to pay seed, equipment, and fuel bills occurs in September, October, and November of the year. In the fall, we also make loans to farmers to purchase feeder livestock.

These loans are all less than a year in maturity because the growing season is less than a year, and the feeding period is considerably less than a year. The loans are paid back after harvest or when the livestock is sold in a lump sum at the end of the loan term.

Mr. Chairman, sound credit practices require that we place the maturity of the loan at the time that our farm customer would have funds from the sale of agricultural products. Section 1281 requires that we pay taxes on income we have not yet received from the borrower.

To illustrate the impact that Section 1281 will have on First State Bank of Warner for the 1986 and 1987 tax years, the additional Federal income tax due to the requirements that we accrue income on short-term loans amounts to $71,000. Since banks in South Dakota also pay a franchise tax, that is a percentage of the Federal income tax paid, this also results in an increase in the State franchise tax.

For many small banks, the additional tax is a year's net income. Net income for First State Bank of Warner was $87,000 in 1987. The total tax impact of Section 1281 will be $75,000 for First State Bank for 1986 and 1987. This is $75,000 that we will not be able to retain as part of our capital structure. This reduces our basic capital structure by approximately six percent; so it is a large chunk of money to a bank of our size.

First State Bank of Warner is still dealing with a distressed farm economy from the past years; and just as our local farm economy is recovering, we are now faced with the added problem of a drought.

Paying tax on income we have not yet received is a real burden under these circumstances, and the reduction in our capital at this time will reduce First State Bank's capability to provide loans to farmers during this difficult time.

I hope the committee can understand that this bill is very important to small banks which serve agricultural communities. Thank you, Mr. Chairman, for allowing me the opportunity to present my comments this morning.

[The prepared statement of Mr. Seaman appears in the appendix.]

Senator BAUCUS. Thank you, Mr. Seaman, for that excellent statement. I come from a State which is similar to yours, and I very much appreciate the problems that small banks face ordinarily and particularly during these times of drought in our part of the country. Mr. James?

STATEMENT OF GERALD I. JAMES, VICE CHAIRMAN, LUMMI INDIAN BUSINESS COUNCIL, BELLINGHAM, WA

Mr. JAMES. Thank you, Mr. Chairman. I appreciate the opportunity to come before you today and give you our position on H.R. 2792. My name is Gerald James. I am the Vice Chairman of the Lummi Tribe. I am also one of eight Commissioners of the Northwest Indian Fish Commission, representing 19 tribes in the State of Washington.

I am also a tribal fisherman. I earn my income from fishing, and I am one of the 65 individuals from my tribe who is being assessed by taxes and penalties by the Internal Revenue Service.

The fishing tribes of the northwest as well as other fishing tribes have reserved rights, either in treaties or in executive orders or acts of Congress, to the rights of taking fish in all their usual and accustomed areas. The Supreme Court in this century has upheld this right seven times. The IRS since 1982 has been attempting to unlawfully diminish our treaties by imposing income tax on our treaty protected resources.

At two separate times, the Interior Department solicitors in 1983 and again in 1985 supported the tribe's position; but in December of 1985, the Justice Department intervened between the two arms of the United States Government—the Interior Department and the Treasury Department—and determined that the Internal Revenue position was a sounder view of the law, under the absurd notion, we feel, that an express exemption had to be in the treaties, taking into consideration that the first income taxes were not enacted until 1913—60 years after our treaties were signed.

In *Washington* v. *Washington Commercial Fishing Vessel Association in 1979*—the infamous Bolt decision—the Supreme Court reaffirmed a long-standing canon of construction of Indian treaties in that treaties are to be interpreted as the Indians understood them; and in no way did we, in 1855, or do we now agree to be taxed on our reserved rights.

Our priority goal is that H.R. 2792 becomes law in the 100th Congress, with the clarification that the treaties are the source of the exemptions, in order to avoid hardships and confrontations from the expected IRS collection efforts, if not passed.

H.R. 2792 provides the basic protections necessary with the exemptions for qualified Indian harvesters, processing, transporting of fish, and all aqua culture, and presuming that aqua culture includes management and rearing of the fish that we harvest.

We do have some recommendations, and our basic concern with the current H.R. 2792 is with Section 1(c)(3), the relationship of the section to treaties, etcetera, and corresponding report language. The Committee on Ways and Means has implied that the legislation, rather than the treaty, is the source of the exemption. This poses a significant threat to the reserved rights doctrine which is a cornerstone of Indian treaty law.

We would appreciate the clarification that H.R. 2792 does not abrogate treaty rights. We have also recommended that managing and rearing activities relating to the tribal fisheries be specifically mentioned in the report language.

We have also proposed that the complex exemption requirements for individual or corporate Indian-owned processing operations be simplified to fit reality and advise also that the lost revenue estimate of $8 million annually is grossly exaggerated. Thank you for allowing me to testify.

[The prepared statement of Mr. James appears in the appendix.]

Senator BAUCUS. Thank you, Mr. James. Mr. Callais?

STATEMENT OF LEE A. CALLAIS, PRESIDENT, SUN SEAFOOD PRODUCTS, LTD., AND SECRETARY/TREASURER, LOUISIANA ASSOCIATION OF CRAB PROCESSORS, GOLDEN MEADOW, LA

Mr. CALLAIS. Thank you, Mr. Chairman and members of the committee. We very much appreciate the opportunity to appear here today to voice our strong support of S. 1821. My name is Lee Callais, President of Sun Seafood Products, Limited of Golden Meadow, LA; and I represent the crab Processors Association of Louisiana.

Also with me today in the audience is Mr. Mike Voison, representing the Oyster Processors of Louisiana, and Mr. Randall Montegut, representing the Crawfish Coop of Louisiana.

In general, we are here today to represent the over 500 seafood processing plants of Louisiana, and these are mostly small, like Congressman Hayes stated earlier in his testimony, mom-and-pop type operations. The main point that we are dealing with in this measure here is a highly skilled labor force that exists in the Louisiana seafood processing industry.

These are the people that actually do the hands-on processing, and they have been a commodity for which the various processing plants compete and the main point of the bill that IRS's classification of them for income tax purposes. We feel that these people should be classified as independent contractors for various reasons.

The seasonality of the work schedule due to unpredictability of the supply of seafood makes these people part-time workers. They are of an independent nature. They shop around for the best working conditions and availability of seafood to process. They are migrant workers who have been known to move around the country in search of different types of work.

They are compensated on a piece-work basis according to how much seafood they peel, pick, shuck, head, filet, or otherwise process.

The current treatment of these workers as an independent group is in line with over 100 years of tradition in the seafood industry of Louisiana, and it is strongly tied to the customs of the area and the nature of the industry in Louisiana.

After years of such treatment as an independent group, IRS is now trying to reclassify them as employees of the processing plants that they work for. This action by IRS threatens to destroy the ability of the small seafood processing plants of Louisiana to operate their businesses.

We ask the Congress to codify into statutory form the long-standing practice of treating these individuals as independent contractors, the people who peel, pick, head, shuck, filet, or otherwise process fish or shellfish and who are compensated on the basis of the quantity of seafood that they process.

In closing, I would like to thank you for letting us speak today in support of S. 1821, making it clear that it is a long-standing practice in the seafood industry and that that is the way that Congress intended for that industry to process.

[The prepared statement of Mr. Callis appears in the appendix.]

Senator **Baucus**. Thank you Mr. Callais.

Mr. Seaman, I think you probably know that certainly not only the Senator from South Dakota but other Senators on this committee have a very deep appreciation for the problems that you have outlined. Your statement is in itself very compelling, very persuasive for the changes you suggest, particularly as they affect small banks.

I want you to know that I think that proposal will have considerable support in this committee. I can't speak for the committee, by any stretch of the imagination, but I do think that there is a lot of support in this committee for what you are suggesting.

Mr. James, I would like to know from you how you recommend the fairly complex allocation problems that may occur with the passage of the bill; and that is, how do you separate those out? That is, income from fishing on tribal lands versus income from fishing on non tribal lands?

I mean, if the bill becomes law, tribal members are obviously going to have to go through more complex calculations to determine taxable income, at least Federal taxable income.

Mr. **James**. Right.

Senator **Baucus**. Do you have any suggestions as to how Treasury could make those provisions easier, so that the tribal members would not have to go through an unnecessarily complex calculation?

Mr. **James**. Currently, we have several members that fish outside of our usual and accustomed areas, and they do currently pay taxes on those incomes. We have quite a few fishermen that fish in Alaska and quite a few that fish in the San Francisco area and also in the bottom fishing industry out on the coast from inside tribes.

Senator **Baucus**. So, that is not a problem thus far?

Mr. **James**. Not a problem, no. And they separate their income now, and we do not currently calculate income from our fishing industry now. It is not something that we have done in the past; and I guess that is one of the problems we have with the lost revenue. How do you lose something that you never had in an $8 million assessment?

Senator **Baucus**. Thank you. Mr. Callais, other than just paying less taxes, what is the major reason for your group of seafood processors being classified as independent contractors? What does it get down to? What is the heart of the matter here?

Nobody likes to pay taxes, but other than that, what does it get down to?

Mr. **Callais**. For example, a small plant can easily go through 200 or 300 such employees during a year because of the turnover, and they shop around so much between the plants to see where they are going to work. It would be uneconomical for each plant to have to compute the taxes and withhold and bear the administrative burdens of keeping the tax information.

On that number of employees, you are talking about some very small plants; and that is the main reason for our point of view why they should be exempted.

Senator **Baucus**. I don't want to impugn the integrity of your group, but there is a recent IRS study which exposes that the bulk, unfortunately, of Americans who are not paying their income taxes—that is, the underground economy—tend to be individuals who are not reporting all their income or who are overexpensing.

That group tends to be, to a large degree, not only big business but also very largely small business and independent contractors. At least, that is the Treasury's assessment. So, I am wondering whether seafood processors, if they are classified as independent contractors, can give an assurance that all the legally due taxes will be paid because we do have a big underground economy in this country.

I think one reason probably for the Treasury position is that they are better able to make sure that people are paying their share, whether it is payroll taxes or whatever. What assurances can your group make that all taxes owed will be paid?

Mr. **Callais**. What we do is get each worker to sign, testifying on a piece of paper, that they are giving us their correct name, Social Security Number, address, etcetera; and we send in 1099s just like you would on any independent contractor that you have working for you.

Senator **Baucus**. Ms. Harjo, let me give you a chance to testify. You came in late, and I don't want to deprive you of the opportunity to make your statement.

STATEMENT OF SUZAN SHOWN HARJO, EXECUTIVE DIRECTOR, NATIONAL CONGRESS OF AMERICAN INDIANS, WASHINGTON, DC

Ms. **Harjo**. Thank you, Mr. Chairman. It is nice to see you again. The National Congress of American Indians is pleased to testify in support of this bill, if it is to be clarified in Section 3 report language that there is no intent to abrogate any treaty and that this measure is not the sole source of the exclusion from tax in this area.

The treaties themselves, of course, are the source of the exclusion, and we think that that is a very important principle and point to be upheld by the subcommittee. We agree with the solution proposed by Senator Inouye, Chairman of the Senate Select Committee on Indian Affairs that this be handled through report language and sent expeditiously to the President for approval, without it having to go back to the House Ways and Means Committee.

We do believe that, if there is to be further procedural and substantive maneuvering on this legislation, we would like the opportunity to have further matters clarified in addition to the deletion of Section 3 and especially in those areas where lines are drawn between tribes.

We reserve the right to comment further on these matters if this legislation is to be added to, for example, the technical corrections legislation. The policy context within which we view this legislation is set forth in our April 7 communication to the Senate Select Committee on Indian Affairs prior to the markup of S. 727; and that is appended to and made a part of the testimony we are submitting today to you.

These matters are not very complex. They are, however, confusing, as our President so recently demonstrated so very publicly to the world community of nations in Moscow that there is something about Indian treaty rights that is not understood by many policy makers.

If this is to be treated as a revenue measure, we would like to note for the tax consequences people on this and the House Ways and Means Committee that Congress has previously estimated the unilateral abrogation and subsequent compensation under the Fifth Amendment in the trillions of dollars for abrogation of Indian treaty rights.

This Section 3 clarification is vital if we are to avoid generations of protracted litigation. Thank you very much.

I would like to introduce at this time Joe De La Cruz, who is our Portland Area Vice President and the President of the Quinault Nation, and who is here in the audience today. If you have particular questions or wish further information from the perspective of the Quinault Nation in the Portland area, I am sure he would be able to provide that for you on some of the questions that you have just asked. Thank you very much.

[The prepared statement of Ms. Harjo appears in the appendix.]

Senator BAUCUS. Thank you, Ms. Harjo.

I have no further questions of the panel. Senator Daschle?

Senator DASCHLE. Mr. Chairman, thank you. I want to commend Ms. Harjo for her comments and the clarification she has provided the committee on Section 3. With what time I have, however, I would like to address my comments to Mr. Seaman and ask him, if he would, to clarify a couple of things for the committee that I think would be helpful as we deliberate on Section 1281.

The first is the question of size. We have put into the 1986 law, as you know and as you have stated, that taxpayers with gross receipts of less than $5 million be exempt from the requirement that businesses use the accrual method of accounting. How big is your bank, and how reflective of the rest of the South Dakota banking community is your bank?

Mr. SEAMAN. Our bank, Senator, has current assets of $14,500,000 as of June 30. In 1987, our gross income was $1,200,000.

Senator DASCHLE. $1,200,000?

Mr. SEAMAN. That is right.

Senator DASCHLE. What percent of banks in South Dakota do you think would fit the less-than-$5 million description?

Mr. SEAMAN. There are 132 banks in South Dakota; and I think of that total, 106 are under $5 million.

Senator DASCHLE. Could you help us appreciate the impact of the current drought on small banks like those in Montana or South Dakota?

Mr. SEAMAN. The impact is difficult to fully assess at this time, Senator. I think it is obvious to everyone that it is going to have a devastating impact on our State's economy, and lending institutions are going to be called upon, especially in the next year, 1989, to advance substantial sums of money for operating loans.

The better capital structure we have to meet those demands, the more farmers we can help in our farm community.

Senator DASCHLE. Would your bank's situation be aggravated if S. 1239 were not to pass? And, if so, how?

Mr. SEAMAN. S. 1239 immediately takes away $75,000 that would ordinarily be part of our capital structure. By being able to retain that, obviously our capital structure is stronger, which will permit us to generate more loan activity to service our agricultural community.

Senator DASCHLE. Let me just ask, if I could, what you have had to do in order to identify the short-term loans affected by Section 1281? What has the change meant for you in bookkeeping, accounting, and such?

Mr. SEAMAN. I think it was reported earlier by Congressman Daub that banks currently are not required to identify any of their types of loans by maturity.

What we did at First State Bank of Warner was that I prevailed upon my wife to assist me in this. We went through our loan ledger for the entire year and identified those loans which we thought were one year or less of maturity. Then, we took our loan accrual for December 31 of 1986 and 1987, went back, and picked up each one of those individual interest amounts, and then calculated the dollar amount.

Senator DASCHLE. You and your wife did that?

Mr. SEAMAN. That is correct.

Senator DASCHLE. Was this something done over the kitchen table?

Mr. SEAMAN. No, Senator. It was done at our bank. It took a matter of about three weeks, with her working almost full time and myself assisting whenever I could.

Senator DASCHLE. I have to say—and this will be my last comment because I know we are running out of time—that during the time from World War II to 1980, we lost 170 banks in this country. Since 1980, we have lost 600. And I have to believe with the drought and with these kinds of perilous requirements on small banks, that number is going to accelerate even more.

So, I am hopeful that this committee will see fit to put some rationality back into accounting for a small bank such as yours and that the message that you have left with us today will be one that will fall on the ears and certainly be in the minds of those who are going to be making the decision on whether S.1239 should be enacted into law.

I thank you and the other panel members for their contributions this morning. Thank you, Mr. Chairman.

Senator BAUCUS. Mr. James, do you have a brief statement?

Mr. JAMES. Yes, I wondered if I had clarified your question. Usual in an accustomed area that we fish that we deal with that would be tax exempt, we know what those catches are within a 24 to 48 hour period. So, we know what those are. The ones that I was implying in my statement were on restrictions that the Ways and Means Committee put on individual corporations and processors that don't fit reality there.

They are asking for separation of tribes, which don't really fit the way we fish in either the Great Lakes or the northwest. We intermingle with each other's fish; and they are asking that if we put two tribes' fish together or two individuals from different tribes, the individuals have to have a minimum of ten percent ownership in the companies, which is totally unrealistic. They might as well have just written it out of the bill.

Senator BAUCUS. I appreciate that.

Mr. JAMES. Thank you.

Senator BAUCUS. Mr. Seaman?

Mr. SEAMAN. I am sorry, Senator, but I do want to make one more comment. Again, as Congressman Daub said in his testimony, Section 1281 impacts on our bank much heavier than just a regular accrual accounting system because, first of all, we are required to accrue interest on our interest income; but we are not allowed to expense the interest we pay on our deposits.

Second, my accountant has told me that in their experience they are not aware of any other industry that has been impacted like ours that requires a mandatory change in your accounting method, but not allowing a phase-in period of three to four years to permit you to make adjustments to pay those additional taxes.

Senator BAUCUS. I wonder if you would also comment on the supplemental effect of financial deregulation? Does that also have an adverse effect on rural banks? It seems to me that these accounting provisions, along with financial deregulation, are a further burden on rural banks. I wonder if you would comment on that?

Mr. SEAMAN. It seems like—and I don't want to sound like a complainer, but that is the way it is going to come out, I am sure—the requirements under deregulation have resulted in more bureaucracy and more demands on our time to comply with those types of things, rather than concentrating on being a banker.

By being a banker, I mean servicing our local community with loans and providing a place for their deposits.

Senator BAUCUS. Thank you all very much. I appreciate your help here. I notice that Mr. Wray, who was scheduled to appear on a previous panel, is here. Mr. Wray, are you still here?

Mr. WRAY. Yes.

Senator BAUCUS. I am wondering whether an earlier panelist, Ms. Anne Moss of the Pension Rights Center is also here. Fine. Ms. Moss, why don't you proceed. You two are our final panelists.

STATEMENT OF ANNE E. MOSS, DIRECTOR, WOMEN'S PENSION PROJECT, PENSION RIGHTS CENTER, WASHINGTON, DC

Ms. Moss. Thank you. My name is Anne Moss. I am the Deputy Director of the Pension Rights Center and Director of our Center's Women's Pension Project. I appreciate your changing the hearing order today since pension portability is a popular topic this morning.

The Center is a nonprofit group that has been working to make the nation's pension programs fairer for workers and retirees. We thank you for the chance to testify on the new pension proposal, the Pension Portability Act of 1988. I will just summarize my testimony quickly.

Concerning portable pension plans, we support H.R. 1961's principle of encouraging the preservation of retirement money by providing for a transfer of funds directed from a plan to a portable pension plan, a trustee-to-trustee transfer.

We like the idea of funds going directly from the plan to a portable pension plan; in fact, we would prefer that this be the only permissible type of lump sum payment from plans. This would be an even better way of carrying out the bill's objective of preserving lump sums for retirement.

We think the bill could also be strengthened by adopting the objective of providing some inflation protection for workers who leave a job before retirement age. Because the typical pension plan bases a worker's pension on his or her final salary, a worker who leaves a job 20 years before retirement age will be collecting a pension based on a 20-year-old salary.

While H.R. 1961 only gives plans the option of transferring lump sums to portable pension plans, we think that workers should have the same option, not just the plans. This would be true portability. This is especially important where a worker believes a plan is not getting a realistic rate of return on investment.

Pension benefits could also be indexed to inflation while they remain in the plan. It isn't necessary to let employees take benefits out. Plans could be required to adopt some form of performance indexing in which the plan would have to adjust upward the value of the deferred vested pensions only in those years when the plan's rate of return on investment is better than the rate assumed at the time the worker left the plan.

I want to point out that British pension plans are required by law to be indexed to inflation, up to a point.

Essentially, what we are doing is asking Congress to expand the scope of H.R. 1961 and to at least examine the feasibility of providing some type of inflation adjustments. Thank you. That concludes my statement, but I would be happy to answer questions.

[The prepared statement of Ms. Moss appears in the appendix.]

Senator BAUCUS. Thank you, Ms. Moss. Mr. Wray?

STATEMENT OF DAVID L. WRAY, PRESIDENT, PROFIT SHARING COUNCIL OF AMERICA, CHICAGO, IL

Mr. WRAY. Thank you, and I, too, want to extend my gratitude for the rearrangement of the schedule. I am David Wray, President of the Profit Sharing Council of America. The Profit Sharing Council is an association of 1,200 profit sharing companies with one and three-quarter million employees throughout the United States.

The Profit Sharing Council opposes restrictive pension portability legislation. The need for such legislation has not been proven; and, more importantly, it would reduce the incentive of profit sharing.

In the case of deferred profit sharing plans, which are the vast majority of defined contribution plans, it is not true that plan asset accumulations are increasingly being used for current consumption at job termination. If anything, the Tax Reform Act of 1986, which eliminated ten-year averaging and imposed a ten percent penalty, appears to have resulted in a trend toward savings.

It is our experience that the 38 percent tax and penalty bite has been a big incentive to defer larger distributions, and there is little value in forcing deferral of small ones which will be largely demolished by inflation and administrative fees by retirement.

Further, the study upon which much of the argument for restrictive pension portability legislation is based has severe limitations. It is based upon data collected prior to the Tax Reform Act of 1986.

In addition, the questionnaire upon which the study is based anticipated that most distributions would be large, with the result that 84 percent of the respondents' distributions fell in the smallest category, under $5,000. So, it is impossible to establish the value of the vast preponderance of distributions.

Likewise, when queried about their use of the distributions, 62 percent of the respondents replied "Other." So, the key questions—how much and how was it used?—could only be analyzed in a cursory fashion.

There are two other problems with the study. Since the respondents were not asked for the time period at which the distribution was received, the results represent cumulative life experience rather than current activity. Also, the study was done during a severe economic recession, possibly distorting the responses.

Employers share profits with employees as an incentive for increased productivity. In order for their to be a productivity"bang" for the deferred profit sharing buck, the employee must feel ownership of the money. If an employee, especially a younger employee, learns that the money is not his or hers until fifty-nine and a half, the productivity incentive will be lost.

Also, the one and three-quarter million employees of the companies of the Profit Sharing Council of America do not want restrictive pension portability legislation. They want and deserve control over their own money.

However, the Council does not oppose making it easier for those who wish to continue their distributions in a tax deferred status. For example, the Council does not object to making it easier to make plan-to-plan rollovers, or allowing terminated employees to roll both their preimposed tax balances into an IRA.

In conclusion, there is no pension portability problem for deferred profit sharing plans where balances are already portable. Most distributions of any size are already being retained voluntarily in tax deferred status. Most other distributions are so small that there is little value in keeping them tax deferred.

Further, forcing deferral of all distributions would sacrifice the incentive value of profit sharing, a very high price. Thank you for this opportunity to testify. I will be happy to answer any questions.

Senator BAUCUS. Thank you both very much, and I appreciate your changing your schedules to come over here after testifying on the House side.

[The prepared statements of Mr. Wray and Senators Inouye and Cranston appear in the appendix.]

Senator BAUCUS. The bill raises a very interesting subject. It is one that this Congress will have to address very quickly. I don't know whether we will address it this year; in fact, I suspect we will not, but I do think you have added a lot to the debate. Congressman Jeffords, when he was here earlier, testified quite well, I think, to the need for portability of pension benefits.

There are many commentators who have written on the need for greater portability, and I think that they make some very good points. It is question, I think, that we will have to address a little more fully and more thoroughly in order to resolve it correctly.

In the meantime, I very much appreciate the effort you have given to the issue. Thank you very much.

Mr. WRAY. Thank you.

Ms. MOSS. Thank you.

Senator BAUCUS. The hearing is adjourned.

[Whereupon, at 12:34 p.m., the hearing was adjourned.]

APPENDIX

ALPHABETICAL LIST AND MATERIAL SUBMITTED

OPENING STATEMENT OF

SENATOR WILLIAM L. ARMSTRONG

ON

S-1239 AND S-2078 (S-2291)

SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
JULY 12, 1988

Mr. Chairman, I am pleased that you are providing this opportunity for views to be heard on two measures that I have introduced.

The first, S-1239, would clarify what many of us thought was the outcome of the Tax Reform Act of 1986, that allowed organizations with average annual gross receipts of $5 million or less to continue to use the cash method of accounting for tax purposes. It turns out the situation for banks was complicated by another section of that Act which could require that short-term obligations of those institutions be accounted for on an accrual basis. This has a very negative effect for agricultural lenders. S-1239 would correct this problem.

The second bill, S-2078, would require the approval, by majority vote, of all employees before an Employee Stock Ownership Plan (ESOP) can be considered a qualified plan for tax purposes. This adds a procedural safeguard when an

ESOP is established and this is necessary because there have been instances where the ESOP concept has been abused and the employee/shareholder of the company could hardly be considered the beneficiary of such a plan.

Mr. Chairman, I would like to submit for the record a full explanation of these measures. Thank you.

S-1239

S-1239 would clarify tax law so that small banks, particularly agricultural banks, will be able to retain the cash method of accounting. This clarification is needed so that these lenders will not be required to pay taxes on loans for which payment has not yet been received. Many small, rural banks are under financial stress. To ask these lenders to pay taxes on income they have not received is simply not wise. Moreover, it was clearly not the intent of Congress in passing last year's tax reform bill to impose such taxation.

Here's the background: Corporations used to be be able to choose between the cash method or the accrual method as their system of accounting for tax purposes. Under cash accounting, income is recognized for tax purposes, when actual payments are received. Under accrual accounting, income is recognized when all events have occurred that establish the right to receive income.

The Tax Reform Act of 1986 changed all this. That law tried to reduce the number of corporations using the cash method of accounting. Large corporations could no longer use the cash method of accounting. Only individuals, some farming businesses, qualified personal service corporations and businesses with average annual gross receipts of $5 million or less can still use the cash basis of accounting. This $5 million test exempted many small, independent, community banks that are critical to the survival of their communities.

But another section of the tax reform legislation effectively required that short-term obligations must be accounted for on an accrual basis. Worse, this change retroactively applies back to September 27, 1985. Banks are thus forced to file amended returns. In other words, a small bank using the cash method of accounting must use the accrual method for income earned on short term loans. Imposing two methods of accounting plus requiring banks to pay taxes on income not yet received -- all on a retroactive basis -- can be a hardship.

I note, Mr. Chairman, that both the Senate and House committee reports accompanying the Tax Reform Act say this latter section that is causing the problem applies only to "...those for whom the cash method of accounting for interest income from short-term obligations is considered inappropriate." Clearly, then, Congress did not intend to require those allowed to use cash accounting to be forced to use accrual accounting for these short-term obligations. S-1239 simply makes the law conform to Congressional intent.

Many agricultural loans are made on a fixed rate basis and payable on an annual basis. Such loans may straddle the bank's taxable year. Requiring a cash basis bank to accrue income from those loans in one tax year when payment comes in another tax year is contrary to the intent of preserving the less complicated method of cash basis accounting for small firms.

This is not just an operational problem for community banks, but a financial one as well. A cash basis bank may have a heavy concentration of short-term agricultural loans. If income from these loans has to be brought into income on an accrual basis for tax purposes, this adds additional financial demands on those institutions.

What this bill accomplishes is this: It clarifies that for banks who use the cash method of accounting that they can also account for the income from short-term obligations for tax purposes using the cash method. The bill modifies the retroactive nature of the Tax Reform Act of 1986 to insure that banks qualifying to use this method of accounting will be spared the necessity of having to file amended returns for 1985. Short-term obligations are meant to include loans to individuals and businesses where there is stated interest or acquisition discount, of one year duration or less. It does not include T-bills, government securities or related obligations.

S-2078 (S-2291)

Self-determination, as a method of decision-making in a political or practical sense is an honored and respected tradition in this nation. Votes, polls and opinion surveys are some of the ways American's satisfy their need to know what their fellow citizens are thinking. I believe there may be a need to extend the principle of self-determination to some facets of employee benefit decisions -- specifically the decision to initiate an employee stock ownership plan (ESOP).

This legislation amends the Internal Revenue Code to establish that before an ESOP is established that the following must occur:

1. Notice must be provided to the employees by the employer explaining all material facts concerning the plan including a) whether assets will be transferred to the plan from any other plan and whether the plan will replace such other plan, b) the terms of the plan, and c) the terms of the plan from which the assets are being transferred (if any).

2. A majority of the employees of the employer establishing the plan must approve of the plan by secret ballot within a reasonable time after notification to employees.

3. The Secretary of the Treasury may deny qualification to an ESOP where the voting rights of the employee-shareholders or beneficiaries are not substantially similar to the voting rights of shareholders who hold the same class of securities directly.

ESOP's were conceived as a means to provide employees with a greater ability to become shareholders in the organizations they work for and both company and employee would benefit. I have come to learn that beyond this threshold there are questions to be answered such as whether a majority of those affected approve of the conditions under which the ESOP is to be adopted?

It is important to realize that the ESOP might be formed as an addition to existing pension rules, in lieu of them or some combination thereof. In some cases the existing pension plan is terminated and excess assets might be used to fund the ESOP. The question for the employees can be quite significant as it applies to their future retirement security.

These employees are asking legitimate questions: Is this a good deal? What will the stock be worth when I retire? Would I be better off with a defined benefit plan upon retirement age?

Questions like these are ones we have been asked to consider by the General Assembly of Colorado when they passed the following resolution:

> "Be It Resolved by the House of Representatives of the Fifty-sixth General Assembly of the State of Colorado, the Senate concurring herein:
>
> (1) That we, the members of the General Assembly, support the application of the principle of "One Person One Vote" to Employee Stock Ownership Plans which would give employees of a corporation the right to cast their votes on issues pertaining to an Employee Stock Ownership Plan.
>
> (2) That we, the members of the General Assembly, urge the Congress of the United States to enact legislation which would require all Employee Stock Ownership Plans to be approved by a majority vote of all employees of a corporation in order to become effective.
>
> Be It Further Resolved, That copies of this Resolution be transmitted to members of the Colorado Congressional Delegation, to members of the Labor and Human Resources Committee and the Banking Committee of the United States Senate, and to members of the Banking Committee and the Committee on Education and Labor of the United States House of Representatives, and to the management of United Airlines."

The Employee Benefit Research Institute in a recent publication had this to say about ESOP's:

> "ESOP's can provide employees with substantial financial benefits through stock ownership while providing companies with attractive tax advantages and a powerful financial tool. By making employees part-owners of the business, companies may also realize productivity improvements, since workers benefit directly from corporate profitability and are thus working in their own interest...[but] there are also risks that should be considered. Because the ESOP is invested primarily in employer securities, the success of the ESOP depends on the long-term performance of the company and its stock."

Authorities therefore recognize the risks involved even when the plans are established with the employees best interests in mind. But there is another disturbing development occurring with regard to the establishment of ESOP's and some believe that in these cases employees are just pawns in a larger struggle — the struggle over control of the corporation.

The use of ESOP's in contests for control of a corporation was the subject of hearings in June of 1987 by the Senate Committee on Banking, Housing and Urban Affairs. What became clear is this. ESOP's are frequently used in corporate takeovers by any, and every party involved.

ESOP's can be used by existing management and serve their needs by establishing a friendly market for large blocks of stock, providing a source of lower rate financing to defend against takeovers, providing tax deductions, and they can be substituted for other retirement plans.

ESOP's can be used by some or all employees to take the company private in good times and in bad. ESOP's can be used by outside bidders to assist their cause when tender offers are made for shares held by the ESOP.

Unintended though it may be, ESOP's have become a factor in corporate finance and the implication for those employees, for whom the ESOP was established, is not clear. In one instance an outside bidder favored by management was granted what is called a "lock-up" that prevented employee shareholders from entertaining additional or even higher bids from other sources. This example illustrates what little practical influence employees may have when it comes to major decisions with regard to their own shares. It also appears that employee shareholders may be denied their rights as shareholders if the ownership is within an ESOP, rights that would not be denied if they owned those shares directly.

The hearing held by the Senate Banking Committee raised troubling questions regarding the actual value to the employee, for whom the ESOP is established. The benefits can range from very good to very questionable and the committee's attention then focused on what mechanisms exist to provide employees adequate information and influence over the ESOP. The answers were not very reassuring.

The following excerpts from Mr. Randy Barber of the Center for Economic Organizing at the June 26, 1987 hearing on ESOP's provide some indication of what voting rights exist for employee-shareholders, the role of trustees and the Board of Directors regarding essential decision-making activities:

> "The tax code requires a resolution from a company's Board of Directors to establish an ESOP, and by definition, only incumbent Directors can grant life to an ESOP."
>
> "Thus, management and the existing owners enjoy a sort of legislated noblesse oblige with respect to the terms under which they bestow ownership on their employees, even as they use taxpayer concessions to do so."
>
> "Although there are requirements that participants be given the right to vote the stock in their accounts on some issues under some circumstances, management still has broad rights to severely limit the authority of participants in determining the future of the company."
>
> "For instance, all unallocated stock may be voted by a trustee selected by management. In a leveraged ESOP, this could include the majority of stock in the ESOP for number of years."
>
> "A trustee, following the Department of Labor's guidance may over-ride participant votes, and in most cases, will vote unallocated shares in the ESOP as he or she deems appropriate."

The Honorable Russell B. Long, a former colleague and past Chairman of the Senate Finance Committee, a noted authority on ESOP's, provided the Senate Banking Committee with a request to legislate on this matter. Senator Long cited a troubling legal decision that suggests that an ESOP trustee, in responding to a tender offer, may not be permitted to rely on employees' directions. That case is Danaker v. Chicago Pneumatic Tool Co., 635 F. Supp. 246 (S.D.N.Y.) and it involved the duty of the fiduciary to accept the highest offer for shares. In his testimony Senator Long objected to this fiduciary standard presuming that employees would favor management's intent to reject such a tender offer. That may well have been the employee position, but unless there is a direct employee-shareholder vote on the matter, free of management pressures, then I am not sure the trustee can really know the wishes of those he serves.

This addresses but one aspect of a larger question of just what is the appropriate role of the employee-shareholder at the time of the creation of an ESOP, during a tender offer and when employees themselves may wish to take a company private.

Mr. Chairman, these statements and the statements of others call attention to the need for Congress to consider this matter and determine if the laws and rules in place need to be improved so that existing and potential employee-shareholders can have a more practical role in determining if proposals related to ESOP's are, in fact, in their best interest. This, it seems to me, can only be done on a case-by-case basis which then requires the need to establish a method of effective decision making for the employees.

A majority vote standard to establish an ESOP is one such method of self-determination that may be appropriate and is the method suggested by this legislation. I propose this to my colleagues not as the definitive answer but as a starting point from which more thorough deliberations may take place.

For existing ESOP's there may be other voting methods that might add a degree of fairness to those affected. Proportional voting is a method that would extend the outcome of a majority vote of shares allocated to individuals to those shares that are unallocated and voted by the trustee.

In conclusion, I believe that an effective voting method is the missing essential ingredient of ESOP's and I urge my colleagues to consider the equity that can be achieved by adopting this democratic method of decision-making. It will insure that all pertinent information is available to employees prior to a vote on the initiation of an ESOP and that ESOP employee-shareholders do not lose rights that are otherwise available to direct shareholders of the company.

DESCRIPTION OF TAX BILLS (S. 1239, S. 1821, S. 2078, S. 2409, S. 2484, S. 2611, H.R. 1961, and H.R. 2792)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON JULY 12, 1988

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Finance Subcommittee on Taxation and Debt Management has scheduled a public hearing on July 12, 1988 on the following eight bills: (1) S. 1239 (tax treatment of short-term loans of small banks); (2) S. 1821 (treatment of seafood processors for employment tax purposes); (3) S. 2078 (majority voting requirement for ESOPs); (4) S. 2409 (designation of overpayments and contributions on tax return for the Organ Transplant Trust Fund); (5) S. 2484 (extension and modification of research credit); (6) S. 2611 (disclosure of certain tax return information to the Veterans' Administration); (7) H.R. 1961 (portability of pension plan benefits); and (8) H.R. 2792 (tax treatment of Indian fishing rights).

The first part of the pamphlet[1] is a summary. The second part is a description of the bills, including present law, explanation of the bills, and effective dates.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Bills (S. 1239, S. 1821, S. 2078, S. 2409, S. 2484, S. 2611, H.R. 1961, and H.R. 2792)* (JCS-12-88), July 11, 1988.

I. SUMMARY

1. S. 1239—Senators Armstrong and Daschle

Tax Treatment of Short-Term Loans of Small Banks

Under present law, certain taxpayers must accrue as interest any acquisition discount and stated interest on short-term obligations. For taxpayers that are not subject to this accrual requirement, present law defers the deduction of net direct interest expense with respect to any short-term obligations until the interest income on such short-term obligations is recognized.

The bill would exempt loans made by small banks in the ordinary course of the bank's trade or business from the rules applicable to short-term obligations requiring accrual of any acquisition discount, accrual of stated interest, and the deferral of interest expense. This provision would be effective for loans acquired after July 18, 1984. The bill also would change the effective date of the provision that requires the accrual of stated interest on short-term obligations.

2. S. 1821—Senator Breaux

Treatment of Seafood Processors for Employment Tax Purposes

Under present law, an employer is required, with respect to its employees, to (1) withhold the employees' share of the Federal Insurance Contributions Act (FICA) tax, (2) pay its share of the FICA tax, (3) pay the Federal Unemployment Tax Act (FUTA) tax, and (4) withhold Federal income taxes. FICA and FUTA taxes and Federal income tax withholding apply only with respect to employees. In general, employees are exempt from the tax on self-employment income because they are subject to FICA taxes.

Under the bill, certain seafood processors are excluded from the definition of employees for purposes of the FICA tax, FUTA tax, and Federal income tax withholding, and thus are not subject to such provisions; instead, such seafood processors are subject to the tax on self-employment income. The bill generally applies beginning on January 1, 1988.

3. S. 2078—Senator Armstrong

Majority Vote Requirement for ESOPs

An employee stock ownership plan (ESOP) is a type of qualified pension plan. An ESOP must be designed to invest primarily in employer securities.

Under present law, the decision whether to establish an ESOP is within the discretion of the employer, except in the case of a collectively bargained plan. Present law imposes voting requirements with respect to employer securities allocated to the accounts of ESOP participants and beneficiaries. If the employer maintaining an ESOP has a registration-type class of securities, the ESOP must provide that each participant and beneficiary is entitled to direct the plan trustee how to vote the shares allocated to the participant's or beneficiary's account. If the employer does not have a registration-type class of securities, then each participant and beneficiary is entitled to direct the trustee how to vote shares allocated to his or her account only with respect to certain enumerated issues.

In general, the bill would provide that (1) a plan will not be qualified as an ESOP unless the establishment of the plan is approved by a majority of the employees of the employer establishing the plan, and (2) the Treasury Department may provide that the voting requirements with respect to ESOPs are not satisfied if the voting rights of any participant or beneficiary are not substantially similar to the voting rights of other persons who hold the same class of securities or substantially similar securities.

The majority vote requirement would be effective with respect to plans established after the date of enactment of the bill. The voting rights requirement would be effective with respect to securities acquired after the date of enactment.

4. S. 2409—Senator Bumpers

Designation of Overpayments and Contributions on Tax Return for the Organ Transplant Trust Fund

Under present law, individual taxpayers may elect on their income tax return to allocate $1 ($2 on a joint return) of their tax liability to a fund established to provide financing to Presidential election campaigns. Federal tax law does not permit taxpayers to make contributions for charitable or other purposes through their Federal income tax returns.

The bill would provide that taxpayers could designate on their tax returns all or a portion of their tax refunds (or could make contributions with their returns) to a new trust fund that would defray the cost of necessary organ transplants. The designation of contributions to the trust fund would be effective for returns filed for taxable years ending after the date of enactment.

5. S. 2484—Senators Danforth, Baucus, Wallop, Kerry, Heinz, Durenberger, Chafee, Mitchell, Boren, McCain, Riegle, Bond, Cranston, Wilson, Symms, Bingaman, Rudman, Sanford, DeConcini, Weicker, Grassley, Heflin, and Lautenberg

Extension and Modification of Research Credit

A 20-percent income tax credit is allowed for the amount of qualified research expenditures paid or incurred by a taxpayer during the taxable year that exceeds the average amount of the taxpayer's qualified research expenditures in the preceding three taxable years (the "base period"). The credit also applies to certain payments to universities for basic research. Under present law, the credit is scheduled to expire after December 31, 1988.

The incremental credit is available only for research expenditures paid or incurred by the taxpayer in carrying on an existing trade or business. Thus, under present law no credit is available to a start-up company for research the results of which are intended to be used in its future business activities, or to an existing business for research expenditures incurred for purposes of developing a new line of business.

The bill would make permanent the incremental research credit and the university basic research credit.

Under the bill, a taxpayer could elect either of two methods for computing the incremental research credit. Under either method, a specified credit rate would apply to the amount of the taxpayer's qualified research expenditures in the current year that exceeds a fixed base period amount (subject to an annual adjustment to reflect increases in the GNP growth rate), rather than a moving base period amount as under present law. The credit would be 20 percent of the excess of current-year expenditures over the base, or seven percent of the excess of current-year expenditures over 75 percent of the base.

Also, the bill would modify the present-law trade or business test to extend eligibility for credit to qualified research expenditures where the research results are intended to be used in the active conduct of a future trade or business of the taxpayer.

The bill would be effective for taxable years beginning after December 31, 1988.

6. S. 2611—Senator Cranston

Disclosure of Certain Tax Return Information to Veterans' Administration

The Internal Revenue Code prohibits disclosure of tax returns and return information of taxpayers, with exceptions for authorized disclosure in certain enumerated instances. Any unauthorized disclosure is subject to criminal penalties and civil damages.

The bill[2] would allow disclosure of certain tax return information to the Veterans' Administration for the purpose of determining eligibility for (and the amount of) veterans' pension and other benefits. The bill would be effective on the date of enactment.

7. H.R. 1961

Portability of Pension Plan Benefits

There is no precise definition of portability of pension benefits, and the term is often used to refer to a broad variety of concepts. In general, the term portability refers to an individual's ability to maintain his or her pension benefits after changing employment. Under present law, the social security system provides the greatest degree of portability of retirement benefits. The social security system covers virtually all workers, and benefits are based on all covered employment.

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[2] S. 2611 was favorably reported by the Senate Committee on Veterans' Affairs on July 6, 1988 (S. Rpt. 100–412), and was placed on the Senate Calendar.

In the private pension system, present law includes several provisions intended to facilitate portability by permitting individuals who receive a distribution of benefits to keep the benefit in a tax-favored retirement arrangement (this concept is often referred to as portability of assets). The most significant of these provisions is the ability to roll over pension distributions to an individual retirement account (IRA). In addition, the withdrawal restrictions applicable to tax-qualified retirement plans and the rules regarding taxation of benefits facilitate the ability to keep retirement funds in a tax-favored arrangement until retirement, inasmuch as these provisions generally are designed to provide incentives for individuals to retain pension savings until retirement.

The bill[3] modifies the rules relating to distributions from qualified plans, qualified annuity plans, tax-sheltered annuity contracts, and IRAs. The bill provides that (1) in certain circumstances direct transfers to IRAs are required in lieu of distribution; (2) the Treasury Department may permit the distribution of employee contributions to be rolled over; (3) distributions from IRAs must be made with the consent of the IRA owner; (4) certain spousal rights to survivor benefits are required for IRAs and tax-sheltered annuity contracts; (5) certain nontax provisions are made applicable to pension plans consisting of one or more IRAs; and (6) the rules relating to salary reduction SEPs are modified. The bill is effective for years beginning after 1991.

8. H.R. 2792

Tax Treatment of Indian Fishing Rights

Various treaties, Federal statutes, and executive orders reserve to Indian tribes (mostly in the West and Great Lakes regions) rights to fish for subsistence and commercial purposes both on and off reservations. Because the treaties, statutes, and executive orders were adopted before passage of the Federal income tax, they do not specifically address whether income derived by Indians from protected fishing activities is exempt from taxation.

The bill[4] would provide that income derived by certain Indians and Indian-owned entities from the exercise of fishing rights protected by treaties, Federal statutes, or executive orders is exempt from Federal and State tax, including income, social security, and unemployment compensation insurance taxes. The bill would apply to all taxable years beginning before or after the date of enactment as to which the period of assessment has not expired.

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[3] H.R. 1961 was reported, with amendments, by the House Committee on Education and Labor on June 7, 1988 (H. Rpt. 100-676, Part 1).

[4] H.R. 2792 was passed by the House of Representatives on June 20, 1988. (See also H.Rpt. 100-312, Part 2.)

II. DESCRIPTION OF THE BILLS

1. S. 1239—Senators Armstrong and Daschle

Tax Treatment of Short-Term Loans of Small Banks

Present Law

Required accrual of interest on short-term loans

Under present law, certain taxpayers must accrue as interest (computed on a daily basis) any acquisition discount and stated interest on short-term obligations, i.e., obligations with a fixed maturity date of not more than one year from the date of issue (Code sec. 1281). This accrual requirement applies to accrual-basis taxpayers, banks, regulated investment companies (mutual funds), common trust funds, dealers in short-term obligations, taxpayers that designate the short-term obligations as part of a hedge, and certain taxpayers that stripped an obligation.

The requirement under section 1281(a)(1) for accrual of interest attributable to acquisition discount generally is effective for obligations acquired after July 18, 1984. Taxpayers, however, could elect to apply the provision to all short-term obligations owned by the taxpayer for its first taxable year ending after July 18, 1984; an electing taxpayer was permitted a five-year spread of the income attributable to the change in accounting method for short-term obligations. The accrual of stated interest on short-term obligations under section 1281(a)(2) is effective for obligations acquired after September 27, 1985.[5]

Deferral of interest deduction allocable to short-term obligations

For taxpayers that are not required to accrue acquisition discount and stated interest on short-term obligations, present law defers the deduction of net direct interest expense with respect to any short-term obligations until the interest income on such short-term obligations is recognized (sec. 1282). Net direct interest expense means the excess, if any, of the amount of interest paid or accrued during the taxable year on indebtedness incurred or continued to purchase or carry a short-term obligation, over the aggregate amount of interest includible in gross income for the taxable year with respect to such obligation.

Explanation of the Bill

The bill would exempt loans made by a small bank in the ordinary course of the bank's trade or business from the rules applicable to short-term obligations requiring accrual of any acquisition discount, accrual of stated interest, and the deferral of interest expense. A bank would be considered a small bank for this purpose if, in general, its average annual gross receipts do not exceed $5 million. This provision would be effective for obligations acquired after July 18, 1984.

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[5] The Technical Corrections Act of 1988 (S. 2238), sec. 118(c)(1), would make this provision effective for obligations acquired after December 31, 1985.

For entities not affected by the provision above, the bill would change the effective date of the provision which requires the accrual of stated interest on short-term obligations under section 1281(a)(2). Under the bill, such accrual would be required for obligations acquired after October 22, 1986.

2. S. 1821—Senator Breaux

Treatment of Seafood Processors for Employment Tax Purposes

Present Law

Under present law, an employer is required, with respect to its employees, to (1) withhold the employees' share of the Federal Insurance Contributions Act (FICA) tax (sec. 3102), (2) pay its share of the FICA tax (sec. 3111), (3) pay the Federal Unemployment Tax Act (FUTA) tax (sec. 3301), and (4) withhold Federal income taxes (sec. 3402). In general, employees are exempt from the tax on self-employment income (sec. 1401) because they are subject to FICA taxes (sec. 1402(c)).

In taxable years beginning in 1988 and 1989, the rate of tax on self-employment income is 13.02 percent; in taxable years beginning after 1989, the rate is 15.3 percent. The comparable FICA rates (total of employer and employee shares) for the same periods are 15.02 percent and 15.3 percent, respectively. Certain other adjustments apply to the tax on self-employment income that generally are intended to equalize the burden of the FICA taxes and the tax on self-employment income for taxable years beginning after 1989.

The FUTA tax only applies with respect to employees. The minimum net FUTA tax imposed on employees is 0.8 percent (0.6 percent in calendar years after 1990) of the first $7,000 of wages paid to each employee during the year.

Federal income tax withholding only applies with respect to employees.

Explanation of the Bill

Under the bill, certain seafood processors are excluded from the definition of employees for purposes of the FICA tax, FUTA tax, and Federal income tax withholding and thus are exempt from such provisions; instead, such seafood processors are subject to the tax on self-employment income. For this purpose, the term seafood processor means an individual whose remuneration is based on the quantity of fish or shellfish the individual peels, picks, heads, shucks, fillets, or otherwise processes.

Effective Date

The provisions with respect to FICA and FUTA taxes apply to services performed after December 31, 1987. The provisions with respect to income tax withholding and the tax on self-employment income apply to taxable years ending after December 31, 1987.

3. S. 2078—Senator Armstrong

Majority Vote Requirement for ESOPs

Present Law

An employee stock ownership plan (ESOP) is a type of qualified pension plan. An ESOP must be designed to invest primarily in securities of the employer maintaining the plan. An ESOP is either a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan under which employer securities are held for the benefit of employees participating in the plan and their beneficiaries. ESOPs are subject to special requirements in addition to the rules generally applicable to all qualified plans.

ESOPs receive the same favorable tax treatment available with respect to all qualified plans. Thus, an employer maintaining an ESOP receives a current tax deduction for contributions to the ESOP, and plan participants are not taxed on benefits provided by the ESOP until the benefits are actually distributed. In addition, the deduction and contribution limits applicable to ESOPs are generally higher than those applicable to similar types of qualified plans.

For purposes of the ESOP rules, the term employer securities means common stock of the employer (or a member of the controlled group of the employer) that is readily tradable on an established securities market. If there is no such stock, then the term employer securities means common stock issued by the employer (or controlled group member) having a combination of voting power and dividend rights equal to or greater than the class of common stock of the employer (or controlled group member) having the greatest voting power, and that class of common stock of the employer (or controlled group member) having the greatest dividend rights. Employer securities also include certain convertible preferred stock. As long as the stock meets these requirements, an ESOP may hold a special class of stock designed for the ESOP, which is not held by any other shareholder.

Under present law, the decision whether to establish an ESOP or another type of qualified plan is within the discretion of the employer, except in the case of a collectively bargained plan. Present law permits the employer to terminate another qualified plan and replace it with an ESOP. For example, under present law, an employer may terminate a defined benefit plan, and transfer any reversion (i.e., excess assets remaining after satisfaction of all liabilities to employees upon plan termination) to an ESOP. Present law facilitates such transactions by providing that, to the extent the reversion is transferred to an ESOP, it is not includible in the gross income of the employer or subject to the 10-percent excise tax on employer reversions (sec. 4980).

Under present law, ESOPs are subject to certain voting requirements with respect to the stock allocated to the accounts of plan participants and beneficiaries. The particular requirements depend on whether the employer has a registration-type class of securities. In general, a registration-type class of securities is a class of securities that is required to be registered under the Securities Exchange Act of 1934.

An ESOP that is maintained by an employer that has a registration-type class of securities is required to provide that each participant and beneficiary is entitled to direct the trustee how to vote shares allocated to the participant's or beneficiary's account. Thus, in such cases, each participant and beneficiary is entitled to direct voting with respect to every issue on which there is a vote by shareholders.

More limited voting requirements apply if the employer does not have a registration-type class of securities. In such cases, an ESOP is required to provide that plan participants and beneficiaries are entitled to direct the trustee how to vote shares allocated to the participant's or beneficiary's account only with respect to certain enumerated issues. These issues are the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all the assets of a trade or business, or such similar transactions as the Treasury Department may prescribe.

Explanation of the Bill

In general

In general, the bill would provide that (1) a plan will not be qualified as an ESOP unless the establishment of the plan is approved by a majority of the employees of the employer establishing the plan, and (2) the Treasury Department may require that the voting requirements applicable to ESOPs are not satisfied unless the voting rights under the plan are substantially similar to the voting rights of other persons who hold the same class of securities or substantially similar securities.

Majority vote requirement

The bill would provide that a plan is not qualified as an ESOP unless a majority of the employees of the employer establishing the plan approve the establishment of the plan pursuant to an election conducted by secret ballot. The employer would be required to notify employees of all material facts concerning the plan, including whether assets will be transferred to the plan from any other plan and whether the plan will replace such other plan, the terms of the plan, and the terms of the plan (if any) from which the assets are being transferred. The election would be required within a reasonable period after the required notice is provided.

Voting requirements

Under the bill, the Treasury Department would be authorized to provide that the voting requirements applicable to ESOPs are not met if the voting rights of any participant or beneficiary in securities allocated to the account of such participant or beneficiary are not substantially similar to the voting rights of other persons who hold the same class of securities or substantially similar securities.

Effective Date

The provision relating to a majority vote of employees on establishment of an ESOP would be effective with respect to plans established after the date of enactment of the bill.

The provision relating to the voting requirements applicable to an ESOP would be effective with respect to employer securities acquired after the date of enactment of the bill.

4. S. 2409—Senator Bumpers

Designation of Overpayments and Contributions on Tax Return for the Organ Transplant Trust Fund

Present Law

Under present law, individual taxpayers may elect to allocate $1 ($2 on a joint return) of their tax liability to the Presidential Election Campaign Fund, a fund established to provide financing to the campaigns of presidential and vice-presidential candidates (Code sec. 6096). The election is made on the first page of the taxpayer's return. An election to make an allocation to the fund neither increases nor decreases the taxpayer's liability, but merely determines whether the allocated amount will be used by the Federal Government for campaign funding.

No other provisions of Federal tax law permit taxpayers to designate for what purpose the amount of tax owed is to be used by the Government. Present law does not permit taxpayers to make contributions for charitable or other purposes through their Federal income tax return.

The Commissioner of Internal Revenue, in the instructions to Form 1040, has encouraged taxpayers to include with their tax return voluntary contributions to reduce the public debt. Taxpayers wishing to do so must enclose a separate check payable to the Bureau of Public Debt.

Explanation of the Bill

Designation of amounts for Organ Transplant Trust Fund

Under the bill, taxpayers[6] entitled to an income tax refund could irrevocably designate all or any portion of the refund as a contribution to the National Organ Transplant Trust Fund, a trust fund to be established by the bill within the United States Treasury. The bill would require that the designation appear on the first page of the return.

Taxpayers not entitled to a refund, or who wished to make a contribution to the Fund in excess of their refund, could include an additional amount with their return and designate this as a contribution to the Fund. The designation would not increase or decrease the tax liability of a taxpayer for the year covered by the return.

Disposition of amounts in Trust Fund

Under the bill, each State would establish a program to receive payments from the Fund and to provide financial assistance to individuals with a medical condition for which an organ transplant procedure is medically necessary, who lack the financial resources to pay for such procedures. A State also could use funds from the Trust to pay for costs incurred by the State's chief health officer to publicize the availability of the Trust Fund and to solicit contributions to the Fund, except that such payments could not exceed five percent of the total payments received by the State from the Trust Fund for the year.

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[6] It is intended that this provision apply only to individual taxpayers.

Specific rules and procedures relating to State residency and the medical and financial eligibility of individuals for benefits under a State's program, which medical expenses would be eligible for payments from the program, the maximum amounts payable, the terms and conditions under which payment will be made to eligible individuals, and other relevant determinations, would be prescribed by regulations issued by the chief health officer of each State.

Amounts in the National Organ Transplant Trust Fund would be disbursed by the Secretary of the Treasury to those States which had been certified by the Secretary of Health and Human Services as carrying out their programs in accordance with the bill and fully accounting for the money received from the Fund for the previous year. Expenses incurred by the Treasury Department in administering the program also would be payable out of the Fund.

Effective Date

The designation of contributions to the Trust Fund would be effective for returns filed for taxable years ending after the date of enactment. The Trust Fund would be established on the date of enactment.

5. S. 2484—Senators Danforth, Baucus, Wallop, Kerry, Heinz, Durenberger, Chafee, Mitchell, Boren, McCain, Riegle, Bond, Cranston, Wilson, Symms, Bingaman, Rudman, Sanford, DeConcini, Weicker, Grassley, Heflin, and Lautenberg

Extension and Modification of the Research Credit

Present Law

Current deduction for certain research expenditures

General rule

As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new product or improve a production process, must be capitalized. However, Code section 174 permits a taxpayer to elect to deduct currently the amount of "research or experimental expenditures" incurred in connection with the taxpayer's trade or business. For example, a taxpayer may elect to deduct currently the costs of wages paid for services performed in qualifying research activities, and of supplies and materials used in such activities, even though these research costs otherwise would have to be capitalized.

The section 174 election does not apply to expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research.[7] Thus, for example, the total cost of a research building or of equipment used for research cannot be deducted currently under section 174 in the year of acquisition. However, the amount of depreciation (cost recovery) allowance for a year with respect to depreciable property used for research may be deducted under sections 167 and 168. Pursuant to the Tax Reform Act of 1986 (the "1986 Act"), machinery and equipment used for research and experimentation are classified as five-year recovery property.

Qualifying expenditures

The Code does not specifically define "research or experimental expenditures" eligible for the section 174 deduction election, except to exclude certain costs. Treasury regulations (sec. 1.174-2(a)) define this term to mean "research and development costs in the experimental or laboratory sense." This includes generally "all such costs incident to the development of an experimental or pilot model, a

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[7] The statute also excludes expenditures to ascertain the existence, location, extent, or quality of mineral deposits (including oil and gas) from eligibility for section 174 elections (sec. 174(d)). However, expenses of developing new and innovative methods of extracting minerals from the ground may be eligible for sec. 174 elections (Rev. Rul. 74-67, 1974-1 C.B. 63). Certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under sec. 616.

plant process, a product, a formula, an invention, or similar property," and also the costs of obtaining a patent on such property.

The present regulations provide that qualifying research expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, the section 174 election cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. sec. 1.174-2(a)).

Minimum tax rules

For purposes of the individual alternative minimum tax, the excess of research expenditures that are expensed under section 174 over 10-year amortization is a preference item. In the case of research expenditures incurred by corporations, expensing under section 174 does not give rise to a minimum tax preference item.

Credit for increasing certain research expenditures

Overview

A 20-percent income tax credit is allowed for certain qualified research expenditures paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer (Code sec. 41). Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the preceding three taxable years (the "base period").[8]

A taxpayer's research expenditures eligible for the 20-percent incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf.

Under present law, the credit is scheduled to expire after December 31, 1988.

Definition of research for credit purposes

In general.—The incremental credit is directed at research undertaken for the purpose of discovering information that is technological in nature and when applied is intended to be useful in developing a new or improved business component for sale or use in the taxpayer's trade or business. In addition, research is eligible for the credit only where substantially all the activities of the research constitute elements of a process of experimentation relating to functional aspects of the business component.

Research.—Research expenditures eligible for the incremental credit must meet the definition of "research or experimental expenditures" eligible for expensing under section 174 (see description above) and the additional requirements and limitations set forth in section 41. Thus, for example, pursuant to the section 174 limitations, the credit is not available for (1) expenditures other than "research and development costs in the experimental or laboratory sense," (2) expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions," (3) costs of acquiring another person's patent, model, production, or process, or (4) research expenditures incurred in connection with literary, historical, or similar projects (Treas. Reg. sec. 1.174-2(a)).[9]

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[8] The Code provides a single research credit, consisting of a 20-percent incremental component and a 20-percent university basic research component. For convenience, this explanation generally refers to these components as the incremental research credit and the university basic research credit.

Research satisfying the section 174 expensing definition is eligible for the credit only if the research is undertaken for the purpose of discovering information (a) that is technological in nature, and also (b) when applied is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, such research is eligible for the credit only if substantially all of the activities of the research constitute elements of a process of experimentation for a functional purpose.

The Code also expressly sets forth exclusions from eligibility for the credit for certain research activities that might otherwise qualify and for certain nonresearch activities, including post-production research activities, duplication or adaptation costs, and surveys, studies, and certain other costs. The costs of developing certain internal-use software are available for the credit only if specified requirements are met. The credit does not apply to any research to the extent funded by any grant, contract, or otherwise by any person or governmental entity.

Computation of allowable credit

General rule.—As a general rule, the incremental credit applies to the amount of qualified research expenditures for the current taxable year that exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. The base period amount is not adjusted for inflation.

New businesses.—For purposes of computing average annual research expenditures during the base period, a new business is treated as having research expenditures of zero for a year during which it was not in existence. However, the taxpayer may be deemed to have expenditures in such a base period year pursuant to the 50-percent limitation rule (described below).

50-percent limitation rule.—Base period research expenditures are deemed to be at least equal to 50 percent of qualified research expenditures for the current year. This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.[10]

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[9] Sec. 174 also excludes from eligibility for expensing (1) expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research, and (2) expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas.

[10] For example, assume that a calendar-year taxpayer is organized on January 1, 1986; makes qualified research expenditures of $100,000 for 1986; and makes qualified research expenditures

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Aggregation rules.—To ensure that the credit is allowed only for actual increases in research expenditures, special rules provide that research expenditures of the taxpayer are aggregated with research expenditures of certain related persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled businesses.

Changes in business ownership.—Special rules apply for computing the credit where a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

Trade or business limitations

The incremental credit is available only for research expenditures paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. With one exception relating to certain research joint ventures, the trade or business test for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. As a result, research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on (within the meaning of sec. 162) by the taxpayer.

Thus, under present law no credit is available to a start-up company for research the results of which are intended to be used in its future business activities, or to an existing business for research expenditures incurred for purposes of developing a new line of business. Also, the credit generally is not available to a limited partnership (or to any partners in such partnership, including a general partner which is an operating company) for partnership expenditures for outside or contract research intended to be transferred by the partnership to another (such as to the general partner) in return for license or royalty payments.

Other limitations and carryover

The research credit is subject to the general business credit limitation (i.e., the credit cannot reduce the taxpayer's tax liability to less than the greater of the taxpayer's tentative minimum tax or 25 percent of the taxpayer's tax liability over $25,000). Any excess amount of the general business credit can be carried back three years and carried forward 15 years, beginning with the earliest year.

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of $260,000 for 1987. The new-business rule provides that the taxpayer is deemed to have base period expenditures of zero for pre-1986 years. Without regard to the 50-percent limitation, the taxpayer's base period expenditures for purposes of determining any credit for 1987 would be the average of its expenditures for 1984 (deemed to be zero), 1985 (deemed to be zero), and 1986 ($100,000), or $33,333. However, by virtue of the 50-percent limitation, the taxpayer's average base period expenditures are deemed to be no less than 50 percent of its current year expenditures ($260,000), or $130,000. Accordingly, the amount of 1987 qualified research expenditures to which the credit applies is limited to $130,000, and the amount of the taxpayer's credit for 1987 is 20 percent of $130,000, or $26,000.

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in an S corporation, the amount of credit that can be used in a particular year cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the amount of tax attributable to that portion of the person's taxable income which is allocable or apportionable to such interest.[11] Any excess credit amount is eligible for the carryover rule described above.

Relation to deduction

The section 41 credit is available for incremental qualified research expenditures for the taxable year whether or not the taxpayer has elected under section 174 to deduct currently research expenditures. Under present law, the amount of any section 174 deduction to which the taxpayer is entitled is not reduced by the amount of any credit allowed for the same research expenditures.

University basic research credit

A 20-percent tax credit also applies to the amount by which corporate cash expenditures (including grants or contributions) paid for university basic research exceed the sum of (1) the greater of two fixed research floors plus (2) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.

The amount of basic research expenditures to which the university basic research credit applies does not enter into the computation of the incremental credit. The remaining amount of basic research expenditures—i.e., the amount to which the university basic research credit does not apply—enters into the incremental credit computation, provided that such expenditures are eligible for the incremental credit.

Explanation of the Bill

a. Extension of credit

The bill would make permanent the incremental research credit and the university basic research credit.

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[11] For example, if in a particular year an individual partner derives no taxable income from a partnership which had made incremental qualified research expenditures, the individual may not use in that year any tax credit resulting from incremental qualified research expenditures of such partnership which otherwise would have been properly allowable to the partner (e.g., where the partnership had paid such research expenditures in carrying on a trade or business of the partnership and where any credit allowable to the partnership with respect to such expenditures had been properly allocated among the partners pursuant to Treasury regulations). If, in this example, the partner had derived taxable income allocable or apportionable to his or her partnership interest, then the amount of credit which may be used in that year by the individual partner may not exceed the lesser of (1) the general business credit limitation amount or (2) the separately computed additional limitation amount applicable to individuals, i.e., the amount of tax owed by the partner on income attributable to his or her partnership interest.

b. Modification of base period for incremental credit

In general

Under the bill, a taxpayer could elect either of two methods for computing the incremental research credit. Under either method, a specified credit rate would apply to the amount of the taxpayer's qualified research expenditures in the current year that exceeds a fixed base period amount (subject to certain adjustments), rather than a moving base period amount as under present law.

Under the first method (the "primary credit"), the base period amount would equal the average of the taxpayer's yearly qualified research expenditures for its taxable years beginning after December 31, 1982 and before January 1, 1988, with two adjustments. The five-year base period amount would be increased by seven percent; this would be a one-time only adjustment. In addition, the base period amount as so computed would be increased each year to reflect the GNP growth rate.[12] If the primary credit is elected, a credit rate of 20 percent would apply to those qualified research expenditures in the current taxable year that exceed the base period amount.

Under the second method (the "alternative credit"), the base period amount would equal 75 percent of the base period amount as computed under the first method. If the taxpayer elects this method, the credit rate would be seven percent.

In any taxable year, a taxpayer can elect either the primary credit or the alternative credit, depending on which method results in the greater credit amount, regardless of the method selected by the taxpayer in the previous year.

New companies

A special rule would apply to determine the base period amount in the case of a taxpayer which did *not* have qualified research expenditures in at least three of the five years in the fixed base period (i.e., taxable years beginning after 1982 and before 1988). This rule would apply both to businesses formed after 1988 and to existing businesses that meet the definition (e.g., a business incorporated in 1984 that prior to 1988 had qualified research expenditures only in 1986 and 1987).

For such a new business, the base period amount would be computed as follows:

For the first taxable year (beginning after 1988) in which the firm incurs qualified research expenditures, and for each of the two succeeding years, the taxpayer's base would be deemed to be equal to 50 percent of its current year qualified research expenditures.

For the fourth year, the taxpayer's base would be deemed equal to the greater of (1) 50 percent of its current year qualified research expenditures or (2) one-third of the average of the taxpayer's actual yearly qualified research expenditures in the first three years, as adjusted to reflect any increase in GNP between the third and fourth year.

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[12] The GNP growth rate means the nominal growth rate of the GNP published by the Bureau of Economic Analysis of the Department of Commerce. The adjustment to the base period would be the percentage (if any) by which GNP for the calendar year preceding the calendar year in which the taxable year begins exceeds GNP for the previous calendar year.

For the fifth year, the taxpayer's base would be deemed equal to the greater of (1) 50 percent of its current year qualified research expenditures or (2) the sum of (a) the base period amount applicable to year four plus (b) 15 percent of the taxpayer's actual qualified research expenditures in year four, with the sum adjusted to reflect any increase in GNP between the fourth and fifth year.

For the sixth year, the taxpayer's base would be deemed equal to the greater of (1) 50 percent of its current year qualified research expenditures or (2) the sum of (a) the base period amount applicable to year five plus (b) 15 percent of the taxpayer's actual qualified research expenditures in year five, with the sum adjusted to reflect any increase in GNP between the fifth and sixth year.

For the seventh year and subsequent years, the taxpayer's base would equal the base period amount applicable to the prior ↔ year, as adjusted to reflect any increase in GNP from the prior year. As under present law, the taxpayer's base period amount could not be less than 50 percent of its current-year expenditures, regardless of which credit computation method is selected.

c. Extension of credit to start-up businesses

In general

Under the bill, in-house research expenditures would be treated as meeting the "carrying on" test if the taxpayer's principal purpose in making such expenditures is to use the research results in the active conduct of a future trade or business of the taxpayer. Thus, otherwise qualified in-house research expenditures of a start-up firm whose activities have not yet reached the point of constituting a trade or business would be eligible for the credit. (However, contract research expenditures would be eligible for the credit only pursuant to the present-law trade or business test.) If in the year the credit is earned the start-up firm does not have any income tax liability against which the credit could be used, this credit amount would be eligible for the 15-year carryover (subject to the general business credit limitation) provided under current law.

Limitations

The bill would not modify the present-law rule that the credit is not available to any partners (whether businesses or investors) in a partnership that does not meet the trade or business test at the partnership level.

Under the bill, as under present law, base period research expenditures would be treated as at least equal to 50 percent of qualified research expenditures for the current year.

Also, the bill would not affect the special present-law limitation on use of the credit by individuals. Under that limitation, in the case of an individual who owns an interest in an unincorporated trade or business, is a partner in a partnership, is a shareholder in an S corporation, or is a beneficiary of a trust or estate, the amount of credit that can be used in a particular year cannot exceed an amount (separately computed with respect to the person's interest in the business or entity) equal to the tax attributable to that portion of the individual's taxable income that is allocable or apportionable to such interest.

Effective Date

The provisions would be effective for taxable years beginning after December 31, 1988.

6. S. 2611—Senator Cranston

Disclosure of Certain Tax Return Information to Veterans' Administration

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information of taxpayers, with exceptions for authorized disclosure in certain enumerated instances (Code sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

Among the disclosures permitted under the Code is disclosure of return information to Federal, State, and local agencies administering certain programs under the Social Security Act or the Food Stamp Act of 1977. This disclosure, pursuant to a written request by the agency, is for the purpose of determining eligibility for, and the correct amount of benefits under, certain enumerated programs. Any authorized recipient of return information must maintain a system of safeguards to protect against unauthorized redisclosure of the information.

Explanation of the Bill

The bill[13] would allow disclosure of certain tax return information to the Veterans' Administration to assist it in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension and other programs.

The Veterans' Administration would be required to comply with the safeguards presently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

Effective Date

The bill would be effective on the date of enactment.

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[13] S. 2611 was favorably reported by the Senate Committee on Veterans' Affairs on July 6, 1988 (S. Rpt. 100-412), and was placed on the Senate Calendar.

7. H.R. 1961

Portability of Pension Plan Benefits

Background

There is no precise definition of portability of pension benefits, and the term is often used to refer to a broad range of concepts. In general terms, portability refers to the ability to maintain pension benefits following a change in employment. In order to evaluate any pension portability proposal, it is helpful to understand what is meant by portability, and what aspect of portability any particular proposal means to address.

The most discussed concepts of portability generally fall into three categories: (1) portability of benefits, which generally refers to vesting; (2) portability of service (also sometimes called portability of credited service or portability of service history), which refers to the ability to count years of service under a plan of a prior employer in determining benefits under a plan of a new employer; and (3) portability of assets (also sometimes called portability of current or present value), which refers to the ability to maintain a distribution of benefits in another retirement arrangement.

In addition, issues of coverage (i.e., what employees are covered under private pension plans) and preservation of benefits (i.e., whether an individual saves a distribution of retirement benefits or spends the distribution for preretirement purposes) often arise in discussions on portability. H.R. 1961 (described below) generally relates to portability of assets and coverage issues.

Present Law

In general

Under present law, the pension system that provides the greatest degree of portability is the social security system. The social security system provides almost universal coverage for all workers, and benefits are based on all covered employment. Outside the social security system (i.e., in the private pension system), present law requires portability of service in limited circumstances. There are a number of provisions of present law which facilitate portability of assets, the most significant being the ability to roll over distributions to an individual retirement arrangement (IRA). In addition, the withdrawal restrictions applicable to tax-qualified retirement plans, as well as the rules regarding taxation of benefits, are generally designed to provide incentives to individuals to save pension benefits for retirement purposes and not spend them for preretirement uses.

Under a plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan), an employer is allowed a deduction for contributions (within limits) to a trust to provide employee benefits. Similar rules apply to plans funded with annuity contracts. A qualified plan may be a pension, profit-sharing, or stock bonus plan.

An employer's deductions and an employee's benefits under a qualified plan may be limited by reference to the employee's compensation. The Code also imposes overall limits on benefits or contributions that may be provided under qualified plans.

Under a qualified plan, employees do not include benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred.

In addition, employees may make after-tax contributions to a qualified plan and defer taxation on the earnings on such contributions until distribution from the plan. An employee may also make elective deferrals to a qualified plan on a salary reduction basis. Elective deferrals are excludable from gross income when made, and are not taxed until distributed from the plan.

Benefits or contributions under a qualified plan are subject to standards designed to prohibit discrimination in favor of highly compensated employees. In addition, qualified plans are required to meet minimum standards relating to coverage (what employees participate in the plan), vesting (the time at which an employee's benefit becomes nonforfeitable), and benefit accrual (the rate at which an employee earns a benefit). Also, minimum funding standards apply to the rate at which employer contributions are required to be made to ensure the solvency of pension plans.

A simplified employee pension (SEP) is another type of tax-favored retirement arrangement under which the employer contributes directly to an IRA established for the employee. A contribution must be made for each employee who is at least age 21, has performed service during at least three of the immediately preceding five years, and received at least $300 of compensation from the employer. Contributions must bear a uniform relationship to compensation. Under the Tax Reform Act of 1986, employers with less than 25 employees may establish SEPs on a salary reduction basis. Like qualified plans, contributions to SEPs are excludable from income and earnings accumulate on a tax-deferred basis.

Portability of assets

In general

There are a number of provisions in present law that facilitate portability of assets. Present law encourages portability by permitting assets to be rolled over or to be transferred from one tax-favored retirement arrangement to another, and by providing incentives to individuals to save amounts received from retirement plans for retirement purposes.

IRA rollovers

An individual may generally roll over a distribution received from a qualified plan to an IRA if (1) the distribution is a total distribution of the individual's entire interest in the plan, or (2) the distribution is a qualified partial distribution. To the extent a distribution is rolled over into an IRA, it is not includible in income and is not subject to the 10-percent additional income tax on early distributions (see below). Of course, when such amounts are subsequently distributed from the IRA, they are includible in income and subject to the 10-percent additional income tax unless an exception to the tax applies. Only employer contributions (and income on employer or employee contributions) can be rolled over to an IRA. Distributions of employee contributions cannot be rolled over.

A total distribution may be rolled over to an IRA if it is made (1) because of the death of the individual; (2) after the individual has attained age 59-1/2; (3) because of termination of employment (other than in the case of a self-employed person); or (4) in the case of self-employed persons only, after the individual becomes permanently disabled. In the case of these distributions, a distribution is a total distribution only if it includes the individual's complete share in all of the employer's pension plans, or profit-sharing plans, or stock bonus plans. That is, for this purpose, all plans of the same type are treated as a single plan.

A total distribution may also be rolled over if it is made because of a termination of a plan. In order to qualify as a partial distribution, a distribution must be at least 50 percent of the individual's interest in the plan and meet certain other requirements.

Tax-free rollovers and transfers between IRAs are permitted, although certain restrictions may apply.

Rollovers and transfers to another qualified plan

Distributions from qualified retirement plans can generally be rolled over to another qualified plan or transferred to another qualified plan on the same basis that distributions can be rolled over to an IRA, except that partial distributions may only be rolled over to an IRA. Present law does not require that plans permit transfers or rollovers from another qualified plan. Plan provisions permitting such transactions are likely to be most prevalent in the case of related companies or where there has been a merger or acquisition.

Incentives to retain funds for retirement purposes

In some cases, present law restricts the ability of employees to obtain a distribution from a qualified retirement plan prior to termination of employment. In the case of pension plans, i.e., defined benefit plans and money purchase pension plans, distributions cannot be made prior to termination of employment. Elective contributions to qualified cash or deferred arrangements (sec. 401(k) plans) cannot be distributed prior to termination of employment, attainment of age 59-1/2, death, disability, or financial hardship. Contributions to profit-sharing and stock bonus plans generally can be distributed within two years of when they were contributed.

Employee contributions generally may be withdrawn at any time. A plan may impose stricter restrictions on plan distributions than those imposed by the qualification rules.

The qualification rules generally require that a distribution be available upon the attainment of normal retirement age. Whether an employee who terminates employment prior to normal retirement age has the right to obtain a current distribution of the value of his or her benefit depends on the terms of the plan. Defined contribution plans generally permit a distribution of the employee's account balance upon termination of employment. In defined benefit plans, there are not separate accounts for each individual and, as a result, distributions often are not available until retirement age. Some defined benefit plans prefer not to make lump-sum distributions, because doing so can affect the funded status of the plan.

If the present value of the employee's benefit does not exceed $3,500, the benefit may be distributed upon termination of employment to the individual, without the individual's consent. Many plans, including both defined contribution plans and defined benefit plans, will cash out benefits of less than $3,500 because the employer will want to avoid the administrative burdens of keeping track of small benefits for former employees.

If the present value of the individual's benefit exceeds $3,500, then the benefit cannot be distributed prior to the later of normal retirement age or age 62, unless the participant consents to the distribution. Thus, participants with larger benefits have the option of deferring a plan distribution until retirement age.

Taxation of distributions

A number of rules regarding taxation of distributions are designed to encourage individuals to save distributions for retirement purposes rather than use them for current consumption.

For example, the Tax Reform Act of 1986 (the 1986 Act) added a 10-percent additional income tax on all early distributions from qualified retirement plans, including IRAs. Prior to the 1986 Act, a similar 10-percent tax applied to early distributions from IRAs and early distributions to certain "key employees," such as five-percent owners, from a qualified plan.

The tax is an additional income tax, so it only applies to the portion of a distribution includible in income. Thus, the tax does not apply to distributions of employee contributions or to the portion of a distribution that is rolled over to another qualified plan or an IRA.

In addition, the additional tax does not apply to distributions (1) after attainment of age 59-1/2; (2) due to the death of the individual; (3) due to the disability of the individual; (4) used to pay medical expenses that would be deductible if the individual itemized deductions (not applicable to IRAs); (5) that are part of a series of substantially equal periodic payments made for the life or life expectancy of the individual (or the joint lives or joint life expectancies of the individual and his or her spouse); (6) made in the case of an employee who separated from service after attainment of age 55 (not applicable to IRAs); (7) from an employee stock ownership plan; or (8) made pursuant to a qualified domestic relations order (not applicable to IRAs).

Other changes in the 1986 Act were also designed to reduce the incentive to take distributions prior to retirement. Under the law prior to the 1986 Act, an individual who received a lump-sum distribution could elect to apply 10-year income averaging to the distribution, which treated the distribution as if it had been received over a 10-year period. In addition, under prior law, the portion of a lump-sum distribution attributable to contributions prior to January 1, 1974, could qualify for treatment as long-term capital gains.

The 1986 Act phased out long-term capital gain treatment over six years and replaced 10-year forward averaging with five-year forward averaging. In addition, averaging may be elected only after the individual has attained age 59-1/2, and only one such election may be made.

Explanation of the Bill

In general

H.R. 1961[14] modifies the rules relating to distributions from qualified plans (sec. 401(a)), qualified annuity plans (sec. 403(a)), tax-sheltered annuity contracts (sec. 403(b)), and IRAs (sec. 408). Generally, the bill provides that (1) in certain circumstances, direct transfers to IRAs are required in lieu of distributions; (2) the Treasury Department may permit the distribution of employee contributions to be rolled over; (3) distributions from IRAs must be made with the consent of the IRA owner; (4) certain spousal rights to survivor benefits are required for IRAs and tax-sheltered annuity contracts; (5) certain nontax provisions are made applicable to pension plans consisting of one or more IRAs; and (6) the rules relating to salary reduction SEPs are modified.

Transfers

In general, the bill requires that single-sum distributions to employees or their spouses from qualified plans, qualified annuity plans, and tax-sheltered annuity contracts (qualified retirement plans) be made in the form of a direct trustee-to-trustee transfer to an IRA. This requirement does not apply, however, if (1) the present value of the employee's accrued benefit exceeds $3,500, (2) a different form of benefit is elected, and (3) commencement of payment of the benefit is not deferred. This requirement also generally does not apply to governmental plans, church plans, certain frozen plans, and certain plans to which employers do not contribute.

The bill also requires that an individual be permitted to transfer IRA assets to another IRA or to a qualified retirement plan that accepts such transfers.

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[14] H.R. 1961 was reported, with amendments, by the House Committee on Education and Labor on June 7, 1988 (H.Rpt. 100-676, Part 1). The bill was referred jointly to the Committee on Education and Labor and the Committee on Ways and Means.

H.R. 1961, as reported, has the same provisions as S. 2343 (Senator Quayle).

Rollovers

Under the bill, the Treasury Department may permit distributions from qualified retirement plans of employee contributions to be rolled over to another such plan or to an IRA.

IRA distributions

Under the bill, certain assets in IRAs may not be distributed without the consent of the IRA owner. The assets subject to this rule are assets transferred from a qualified retirement plan and assets in a SEP. An exception is provided for distributions in the form of a 50-percent qualified joint and survivor annuity or a single life annuity to the extent that such distributions are required by the minimum distribution rules.

Spousal rights

Present law provides an individual with certain rights to survivor benefits with respect to his or her spouse's interest in qualified plan assets. The bill extends these rights to IRAs and tax-sheltered annuity contracts by treating such arrangements as nonpension defined contribution plans. However, with respect to IRAs, such treatment only applies to assets transferred from a qualified retirement plan and assets in a SEP.

IRA pension plans

The bill provides that pension plans consisting of one or more IRAs are subject to certain requirements under Title 1 of ERISA. Generally, IRA pension plans are to be treated as other pension plans under Title 1, except that the funding rules do not apply and only certain rules under Part 2 (generally relating to participation and vesting) apply. In general, the rules applicable under Part 2 are (1) the participation rules (with special rules for SEPs); (2) the prohibition on alienation or assignment; and (3) the vesting rules (with the modification that all interests must be 100 percent vested).

Salary reduction SEPs

Under certain circumstances, the bill allows employers to establish a new type of SEP that permits employees to reduce their salary and contribute the amount of such reduction to the SEP. This alternative arrangement is available to employers (other than State or local governments or tax-exempt organizations) not otherwise maintaining a qualified plan or qualified annuity plan. Under the bill, such salary reduction SEPs are subject to nondiscrimination rules that are similar to, but less restrictive than, the rules applicable under present law to salary reduction SEPs. The bill also modifies certain other nondiscrimination requirements for all SEPs, without regard to whether they allow salary reduction.

Effective Date

The bill is effective for plan years and taxable years beginning after December 31, 1991.

8. H.R. 2792

Tax Treatment of Indian Fishing Rights

Present Law

Various treaties, Federal statutes, and executive orders reserve to Indian tribes (mostly in the West and Great Lakes regions) rights to fish for subsistence and commercial purposes both on and off reservations. Because the treaties, statutes, and executive orders were adopted before passage of the Federal income tax, they do not expressly provide whether income derived by Indians from protected fishing activities is exempt from taxation.

Indians generally are subject to Federal tax in the same manner as other U.S. citizens, absent a specific Federal exemption. Consequently, the Tax Court has ruled in three cases that income derived by Indians from protected fishing activities is taxable, and the Internal Revenue Service has assessed deficiencies in other cases.

Explanation of the Bill

The bill[15] would provide that income derived by individual members of an Indian tribe, or by a qualified Indian entity, from fishing rights-related activity is exempt from Federal and State tax, including income, social security, and unemployment compensation insurance taxes.[16] Fishing rights-related activities would be defined as any activity by a tribe or members of that tribe directly related to harvesting, processing, or transporting fish harvested in the exercise of fishing rights guaranteed to that tribe by treaty, Federal statute, or executive order.

The bill would define a "qualified Indian entity" as an entity in which (1) all of the equity interests are owned by tribal members; (2) substantially all of the management functions are performed by tribal members; and (3) if the entity engages in any substantial processing or transporting of fish, at least 90 percent of the annual gross receipts are derived from the exercise of protected fishing rights.[17] An entity that failed to satisfy any of the criteria of a qualified Indian entity would not be eligible for the exemption from tax provided by the bill; any employee or owner of such an entity would not be eligible under the bill for tax exemption on income received from such entity.

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[15] H.R. 2792 was passed by the House of Representatives on June 20, 1988. (See also H.Rpt. 100-312, Part 2.)

[16] Individuals may derive exempt income through self-employed activities, as employees, or as owners of qualified Indian entities.

In the case of an individual tribal member or a qualified Indian entity, the bill would exempt from taxation only that income "derived" from fishing rights-related activities. Thus, both individual tribal members and qualified Indian entities would be required to allocate income and expenses among fishing rights-related activities and all other activities.[18] Expenses and amounts otherwise deductible that were attributable to income that would be exempt under the bill could not be used by an individual or entity to offset any other income of the individual or entity. Likewise, income that is exempt from tax under the bill would be excluded in determining whether an individual was eligible for social security benefits or unemployment compensation.

Income from Indian fishing activities protected by treaty, Federal statute, or executive order would be exempt from Federal taxes only to the extent provided for by the bill. If income from fishing rights-related activity is exempt from Federal tax, then the bill would prohibit imposition under State or local law of any tax on such income. (However, the bill would not limit exemptions from State and local taxes that may be broader than the exemption it provides.)

Effective Date

The bill would apply to all taxable years beginning before or after the date of enactment as to which the period of assessment has not expired.

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[17] A qualified Indian entity may be jointly owned by members of more than one Indian tribe, provided that the entity is engaged in fishing rights-related activity of each tribe of which the owners are members. If a jointly owned entity engages in substantial processing or transporting of fish, at least 90 percent of the annual gross receipts must be derived from fishing rights-related activities of tribes whose members own at least 10 percent equity interests in the entity. The bill does not affect the income of a tribal government received pursuant to the exercise of an essential governmental function (see Code secs. 115 and 7871; Rev. Rul. 67-284, 1967-2 C.B. 55, 58). However, wages paid to an Indian who was employed by an entity that was owned by his or her tribal government and that engaged in fishing rights-related activities could be exempt from tax under the bill only if the entity satisfied the bill's criteria for a qualified Indian entity (treating the tribal government's ownership as ownership by tribal members).

[18] However, allocations between exempt and taxable income would not be required where all but a de minimis amount of the income of the individual or entity was derived from protected fishing activities.

Statement of Martin Neil Baily

The U.S. economy faces major challenges in the years ahead. There is welcome news that exports are rising and the trade deficit is coming down. But that deficit remains dauntingly large. We have a long way to go yet. There is welcome news that productivity growth in U.S. manufacturing is now running at over 3 percent a year. But in Japan, manufacturing productivity growth last year was over 11 percent, and the European economies are on the move again. If the United States is to retain its position as the most productive economy, we must maintain or even improve our performance. We can hope that the worst of the economic problems of the past 15 years are behind us, but the challenges of the future will be tough.

Improving the economy will take efforts in many directions. The workforce needs more skills, education and motivation to add to its contribution. Investment in new plant and equipment should increase if we are to equip the workforce appropriately to compete. And the United States must continue to develop the innovative products and processes that have been its competitive strength and its major source of productivity growth. The Federal government has traditionally played an important role in sponsoring technology development and today the National Science Foundation, the Defense Department and other agencies direct resources into basic science and technology. And of course since 1981 the R&D tax credit has been an important part of the Federal commitment to innovation.

It is now widely recognized that commercial R&D is vital to U.S. competitiveness and growth, and that an R&D tax credit can help to overcome the "appropriability problem" with R&D spending. When a company spends its own R&D dollars to develop a new product or process, the benefits spill over outside the company in ways for which the company itself will not receive payment. Competitors will copy the new technology. Research and engineering staff will leave to join other companies or set up their own, taking their knowledge with them. For these reasons the innovating company cannot "appropriate" all of the returns to its own R&D. Some of the benefits accruing to its competitors, its customers and its employees will not be paid for. As a result, firms will spend less on R&D than would be desirable from the perspective of society as a whole, unless there are additional incentives from the government.

Some economists acknowledge the case for government intervention but object to the R&D credit on the grounds that government support should be concentrated only on basic research. There is a need to support basic research, but the evidence suggests that, in the United States, firms do not engage in sufficient commercial R&D spending. Although they use different methodologies and data samples, most studies have reached the same conclusion: Industrial R&D has social returns that far exceed the returns from other kind of investment.[2]

These studies point clearly to the need for increased incentives for private companies to do more R&D. An R&D tax credit increases the efficiency of the market system, rather than distorting it, something that is true of very few other special provisions of the tax code. The strength of the case for an R&D credit has been recognized by the Senate, the House and the Administration, even in the face of the budget deficit problem.

Other economists argue that the government or a committee of experts should be given the task of picking the commercial projects with the highest social payoff. And some even go further and suggest that particular kinds of firms e.g high-tech, smokestack, large or small, should be favored. In some cases, e.g. superconductivity, support for a particular technology project may be warranted. But for the most part, we are uncertain where the highest social returns will be realized, so it is better to give a general incentive that is available to all firms. This is the essential philosophy behind the R&D credit: while the government provides additional leveraging, a broad spectrum of firms decides which projects should be supported.

The use of a tax credit exploits the strength of the private market. Commercial R&D involves finding innovations that will succeed in the market, not just those that are feasible technically. Successful innovation requires knowledge of market conditions and the needs of customers. The tax credit channels Federal support to the people who are best able to choose commercially worthwhile projects and bring them to fruition. We support Federal funding of basic science. But such support is no substitute for the R&D credit. In fact, tax incentives are likely to be more effective in stimulating R&D spending than a grants competition with a similar budgetary cost. When government grants for R&D are made available, private companies will respond by seeking funding for their best projects i.e. those they would undertake anyway. An R&D tax credit, by contrast, can affect decisions at the margin.

The Strengths of the Existing Credit

- The credit that was in effect from 1981-85 increased private R&D spending. In an earlier study we examined the evidence on the effectiveness of the credit and then carried out our own investigation of the data.[3] We reviewed several independent studies that concluded that the credit had succeeded in raising spending, although they found that the impact was not very large. Our own analysis used more up-to-date information than in the other studies and it confirmed that the credit had raised spending. Moreover, our analysis indicted that the credit was more effective than had been thought. The ratio of R&D spending to output during the period when the credit was in effect grew more than twice as rapidly as in the comparable period prior to the enactment of the credit. In a statistical analysis, we found that the credit increased R&D spending in 11 out of the 12 industries studied and raised overall R&D spending by $2.6 billion a year.[4] These results proved robust when we asked if there were alternative explanations of the increased R&D spending over the period.

- The social return to R&D is so high, that the credit is worthwhile even if its impact is small. Many people judge the credit on whether it can encourage more R&D spending than it costs in tax revenues. And the findings we have just described suggest that the 1981-85 credit passed that test. But in fact this is not the correct test. Because the social rate of return to R&D is twice or even four times the return to the private company performing it, this means that it is worthwhile for taxpayers to encourage R&D even if more pessimistic estimates of the credit's effectiveness turn out to be correct. The credit will raise GNP and pay for itself in the long run even with a very conservative view of its impact.

Problems with the Existing Credit

- The credit provides only a small incentive, and its effectiveness is being eroded by revisions of the code. The credit that went into effect in 1981 had a statutory rate of 25 percent on spending above a base level. But the incentive effect was much less than 25 percent, because of the way the base was computed. In particular, current spending increases the future base and thus limits the incremental incentive. We calculate that, on an after tax basis, the original credit reduced the after-tax cost of a proposed new R&D project by only 7 percent. In addition, as Robert Eisner has pointed out, the credit could even act as a disincentive to R&D for a company that was cutting back its R&D spending below its base.

The credit was renewed for three years effective in 1986 at a lower statutory rate and its incentive effect was reduced further because of the reduction in the corporate income tax rate. The credit today provides only about a 5 percent incentive.

The House Ways and Means Committee has recently proposed enacting an offset to the credit when R&D is expensed which would further reduce the incentive -- to about 3.3 percent. An incentive of this magnitude is simply tokenism. It acknowledges the social need to stimulate industrial R&D but does virtually nothing to achieve it. The R&D tax credit cannot be effective unless it provides an adequate incentive. The current credit provides too little incentive and the

Ways and Means proposal would leave us with a credit that was largely ineffective.

- A temporary credit has only a limited impact. Some R&D directors report that the credit has only a minor impact on their R&D budgeting decisions. And no wonder. Not only is the incentive effect small, but companies do not know whether or not the credit will even exist in the future. An R&D project planned today will often involve spending over many years into the future. Indeed it is long-term planning that we wish to encourage in our companies. A credit that will disappear in a couple of years will not provide the stable incentive needed for long-term R&D planning.

- Many companies now miss out on the credit altogether. When the credit was enacted it applied only on spending in excess of the base level. At a time when the majority of companies were raising spending, this was seen as a reasonable tradeoff between the goals of giving an adequate incentive with a minimum of revenue loss. The credit's structure is no longer appropriate for the times. Many U.S. companies have raised their R&D to sales ratios but since their sales levels have fallen or failed to grow rapidly, they cannot maintain increases in R&D at the rate that was achieved in the past.

The scope of the credit should be as broad as possible. Encouraging declining firms to undertake more R&D could be as beneficial socially as encouraging those that are expanding to spend more. The existing credit provides no incentive for companies who have fallen behind in R&D spending to catch up, and provides little incentive for companies that have achieved high levels of R&D spending to hold that level.

The Proposed Restructuring of the Credit

Senators Danforth, Baucus and twenty-one other senators have introduced S. 2484, the Research and Experimental Credit Extension and Reform Act of 1988. This bill, if enacted, would restructure the credit and make it permanent. We support this bill. The existing tax credit has been a valuable tool to encourage growth and a revised and permanent credit would be much better. The improved design would significantly enhance the efficiency of the Credit by dramatically raising incentives and increasing coverage.

The new credit would be in two parts. The primary credit would be 20 percent on R&D spending in excess of a base level. The base level in 1989 would be 107 percent of the average spending in the years 1983-87. In subsequent years the base would rise in line with the increase in GNP. The secondary credit would be 7 percent on spending in excess of 75 percent of the base level. Companies would be free to choose either credit in each year. A company will choose the primary credit when its spending in a given year is more than 18 percent above its base and will choose the secondary credit for spending levels below this.

Industry-funded R&D in the United States rose by 7.4 percent a year on average from 1983-84 to 1986-87. An individual company that had matched this rate of increase and continued to do so through 1989 would choose the primary credit. Since its additional spending in 1989 would not affect its base in future years, with the new credit, the cost of its marginal R&D project would now be reduced on an after tax basis by the full credit. This would result in an after-tax incentive about six times as large as the old credit. The new credit would provide a substantial incentive to add extra projects. While the incremental impact of the credit would be significant, the subsidy to R&D would remain a relatively small proportion of total R&D spending. Our representative company would receive a credit equal to only 3.5 percent of its 1989 R&D spending. This representative company would be given an important incentive at a relatively small cost to the Treasury.

What about companies whose R&D spending grows more slowly? A company whose R&D had grown by 3 percent a year after 1983 would select the secondary credit. This would provide an incentive which is about twice as large as that received by eligible companies under the old credit formula. Moreover, under the old credit formula many such companies would not be eligible for the credit and some might have found themselves with an incentive to reduce R&D spending. However, no such disincentives occur with the new formula.

As with the primary credit, the improved incentives for additional projects is achieved at relatively small overall costs. A company eligible for the secondary credit but just below the threshold for the primary credit, would receive a subsidy equal to only 2.4 percent of its 1989 R&D spending.

With both the primary and secondary credits, over time, companies will have their bases rise automatically. In future years, they will have to increase spending as fast or faster than GNP in order to avoid a gradual reduction of their credit.

The Advantages of the Proposed Credit

- For companies whose R&D is growing strongly, the proposed credit provides an incentive for additional R&D six times as large as the current credit and nine times as large as the Ways and Means proposal. It does this with a very modest loss of tax revenue. By combining a high credit rate for any additional project with a low average rate overall it does exactly what it should: It rewards companies that add to their R&D spending and, for the most part, avoids rewarding them for R&D that was being done anyway.

- The proposed credit broadens the range of companies eligible for the credit and encourages those that have had hard times to resume the growth of their R&D spending. It provides a solid incentive to these companies but, again, the average credit rate is low. The 7 percent incentive in the secondary credit is still twice as high as the incentive in the Ways and Means proposal.

Conclusions

The proposed credit represents a substantial improvement over the existing credit. The U.S. economy today is in a rather different phase than the one it was in in 1980-81. R&D spending has grown rapidly since then and now the main task is to hold the new higher level of spending. The new credit would provide an important tool to achieve this. It avoids the adverse incentives built into the existing credit by adjusting the base with GNP rather than in response to each company's own spending.

We urge the Senate to enact S. 2484. Ellin Rosenthal, a reporter for Tax Notes, talked to many people including critics of the existing credit about this proposal and she writes: "No one interviewed for this article opposed the proposal." We urge the Senate to resist efforts either to cut the effective credit rates or make the extension of the credit temporary.

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2. Three complementary studies commissioned by the National Science Foundation support this conclusion. Professor Edwin Mansfield and his associates at the University of Pennsylvania analyzed detailed data on a sample of seventeen typical innovations. They found that the median project in their sample had a rate of return to the firm undertaking it of 15 percent. However, once they took into account the benefits accruing to other firms and consumers, the median return to society was 56 percent. In a similar study Robert R. Nathan Associates found the median social rate of return to be 70 percent, about twice the median private rate of return. And Foster Associates found the median innovation had a social rate of return of 99 percent and a private rate of return of 24 percent.

3. Martin Neil Baily and Robert Z. Lawrence, Tax Policies for Innovation and Competitiveness, study commissioned by the Council on Research and Technology.

4. These results refer to the period 1982-85. The credit was only in effect for part of 1981.

REMARKS OF

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STATEMENT IN SUPPORT OF S. 1821

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

We very much appreciate the opportunity to appear today to voice our strong support of S. 1821.

My name is Lee Callais, President of Sun Seafood, Inc., Golden Meadow, Louisiana, and I represent the Crab Processors of Louisiana; with me is Mr. Mike Voisin, representing the Oyster Processors of Louisiana, and Mr. Randall Montegut, representing the Crawfish Coop of Louisiana.

There are some _____ (number) of Crab Processors in Louisiana, ____ (number) of Shrimp Processors in Louisiana, and ____ (number) of Crawfish Processors in Louisiana. In addition, there are about ____ (number) people who peel, pick, head, shuck, fillet or otherwise process fish and other shellfish (hereinafter referred to as processing specialist) in my area of Louisiana. In all, there are over 500 seafood processing plants in Louisiana.

These plants are all very small "Mom and Pop" businesses. The associations we represent here today are very small compared to what this Committee generally deals with in terms of Associations.

Each processing facility contracts for processing specialists who possess particular skills and know how and provide their services to individual plants based on the daily need of such facilities. This need depends and varies with the batch, catch, boat load, or whatever each facility is able to purchase periodically for processing. Many days, there is no work at all, as there is no seafood to process. Our business is also very seasonal. Everything depends on when and what fish "run".

The processing specialist that supply the know how and hand work are an independent group of individuals who decide for whom they work, when they work, the price they are to receive for the work, and the manner of payment. They work on an incentive basis, that is, they base their compensation on production or a share of the catch. They move at will from plant to plant, and they shop almost daily for the best price and conditions for rendering their services. The plant many times is forced to take whatever processing specialist it can locate as the perishable nature of seafood leaves the facility vulnerable to immediate loss, and it must compete for the specialist available at the time it receives seafood to be processed. There is not an absolutely dependable supply of processing specialists available at all times. Many of the specialists will only work part time.

The current practice in our business and industry in Louisiana for more than 100 years has been to respect these processing specialists as an independent group, which they in truth and fact are. It is a business practice, custom and tradition that has survived in our area because of this mutual respect between the plant and the processing specialist. The business tradition and practice still exists because it is related directly to the habits, customs, and practices of the fishing business along our gulf shores and the law of the sea.

After acknowledging the independent status of these processing specialists for many years, Internal Revenue is now trying to classify these processing specialists as "Employees" of the processing facilities with whom they contract. There is no real basis for such IRS position, but the burden threatens to destroy the ability to do business for most of our plants.

We are asking the Congress to codify, into statutory form, the practice and custom of our businesses which historically treats as independent contractors, individuals who peel, pick, head, shuck, fillet or otherwise process fish or shellfish, and who are compensated on the basis of the quantity of seafood they process.

As I understand it, S. 1821 would make clear that a longstanding practice in the seafood processing industry is the practice that Congress intended for that industry.

Thank you again for this opportunity. We request permission to add to the record of this proceeding more detailed statements from other individual processing facilities.

Joseph J. Cordes
Department of Economics
The George Washington University

INTRODUCTION

I am pleased to have the opportunity to offer my observations on S.2484 to amend the Internal Revenue Code of 1986 to enhance the incentive for increasing research activities. As I understand it, the bill proposes to make permanent a tax credit for research and experimentation as well to modify the present structure of the credit in several important ways. My comments shall be organized around these two broad features of S.2484 since they mirror two major policy questions that should be asked in evaluating the desirability of the proposed legislation. (1) Should an additional financial incentive for the conduct of private R&D become a permanent element of U.S. science and technology policy? (2) If such an incentive were to be adopted, how should it be structured?

THE ROLE OF SUBSIDIES FOR PRIVATE R&D

Devoting resources to R&D is clearly an investment decision involving the current commitment of resources with the expectation of recovering the initial investment plus a return in the future. Such commitments must be financed either through the firm's internally generated funds or through external debt or equity capital.

An important policy question is: are capital markets likely to provide adequate opportunities for economically promising -- as distinguished from technically promising -- innovations to obtain the appropriate level of financing? In earlier work I have done for the Office of Technology Assessment, I have concluded that while American capital markets are generally quite capable of allocating the appropriate level of financing to R&D and industrial innovation there may be some potentially important exceptions.

New, Start-up Firms

The first is the case of new, generally small start-up companies. While such firms have traditionally played an important role in the industrial innovation process, they have often done so in the face of substantial barriers.

Investments in R&D generally promise high returns in exchange for high risk. The uncertain nature of investments in innovation has sometimes been cited as one reason why such investments may fail to be undertaken, even though they appear to be potentially promising.

However, one important lesson of modern financial and capital market theory is that uncertainty about future outcomes is not in and of itself a source of capital market failure. If certain conditions are satisfied, it can be easily demonstrated that risk and uncertainty will be properly reflected in asset prices and/or rates of return.

This in turn implies that capital markets will allocate resources efficiently to risky investment activities, including investments in innovations. This is not to say that every potential innovator will be able to obtain the level of funding which she or he would like to have. Nor does it imply that the cost of capital will the same for risky as for riskless projects. Nevertheless, it does imply that the premium which must be paid by innovators will be not be "out of line" with the true risks of the ventures they seek to finance.

However, this will not be the case if there are systematic obstacles to obtaining and/or acting upon relevant information about such investments. In the case of some innovations, particularly "important" innovations, it is quite likely that investors within the firm may have better information about the potential of of the innovation than will outside investors. As a result of such "assymetric" distribution of information, the availability of internal sources of capital can become an important factor in the decision to innovate because access to external capital is limited. While this consideration may be relatively unimportant to larger, more established firms, it may be quite important in the case of newer, smaller firms. Thus, it is conceivable that financial markets will fail to allocate the appropriate amount of capital to certain types of firms which have traditionally been an important source of innovations.

External Benefits of R&D

It is also widely acknowledged that certain types of R&D have some special attributes. Many, though not all, forms of private R&D generate economic benefits that are not captured fully by the firm conducting the R&D, but instead spill over to other sectors of the economy. In the absence of public support for private R&D, the existence of such spillover benefits means that the financial incentive to undertake certain types of R&D will be weaker than it should be, creating the possibility that potentially valuable social benefits will be unexploited.

Evidence of Market Failures

Arguments such as these establish the theoretical possibility that markets may fail to allocate adequate resources to private R&D. However, relatively little is known about how serious such market failures are in practice. For example, while small, start-up firms may face significant obstacles in obtaining financing for research ventures, many are able to do so. Indeed, the ability of such firms to obtain the capital needed to finance research ventures is a feature of U.S. capital markets that is much admired elsewhere in the industrialized world.

Similarly, there is relatively little evidence on how serious a probem is created by the inability of firms to appropriate all of the social benefits of some forms of R&D. A research study published in 1977 by Edwin Mansfield and his associates provides the following insights. Among the 17 industrial innovations studied by Mansfield _et. al._, 12 produced an estimated flow of social returns in excess of the private returns earned by the innovators. In 5 of these 12 cases, the private return was sufficiently low that, if endowed with the wisdom of hindsight, the innovators might not have undertaken the investment needed to develop the innovation, even though such investments would have been justified on the basis of their social returns. In 5 of the 17 cases, the social return to the innovation was either roughly equal to or less than the private return to the innovators.

The implications of these results may be summarized as follows. (1) Based on past experience, there is evidence that social returns to innovations can exceed the private returns. (2) In some cases this divergence may cause insufficient resources to be devoted to some innovations which are socially but not privately profitable. However, (3) there are also likely to be many instances in which the private returns are sufficiently high to encourage private investment in the innovation, even though the social return may exceed the private return.

Existence of Other Federal Policies in Support of Private R&D

Moreover, even if one concedes that private market failures are likely to be serious in practice, the desirability of adopting a permanent R&D subsidy needs to be evaluated against the backdrop of other policies that are also designed to foster private R&D. For example, a 1985 CBO study notes that the federal government supports private R&D in a number of ways including programs of the National Science Foundation, the National Bureau of Standards, and other federal research laboratories.

Such programs do not directly subsidize the conduct of private R&D. However, they support the conduct of much important basic research as well as the maintenance and development of the scientific and technological base, all of which are crucial inputs into private R&D. In addition to these policies, the National Cooperative Research Act of 1984 has made it easier to engage in research joint ventures, which may make it more profitable for American firms to undertake R&D when there are significant spillover benefits among different parties.

In addition, though R&D spending is intended to create an intangible capital asset, and hence should be capitalized for tax purposes, Section 174 of the Internal Revenue Code permits R&D outlays to instantaneously expensed. While expensing of R&D was originally enacted for administrative reasons, rather than to provide incentives _per se_ to R&D, the effect of the provision is to lower significantly the after-tax cost of conducting industrial R&D.

The presence of other forms of public support for private R&D does not of course preclude adding a permanent subsidy for private R&D to the existing mix of policies. However, it does suggest that the desirability of adopting a permanent subsidy should be judged on the basis of whether such a measure would "add value" to the current policy mix. This in turn depends in part on whether other measures provide adequate incentives for private R&D; or if they do not, whether they could be modified to do so. Unfortunately, there is even less information on this latter point than there is about the practical significance of private market failures.

Implications

Thus, while economists have learned some things about the causes and the process of industrial innovation, there is not enough information available at this time to conclude with certainty that a permanent financial subsidy for private R&D is needed. Indeed, as the Council of Economic Advisers noted in the 1988 _Economic Report of the President_, "...(while) the decrease in the U.S. lead in science and technology has prompted some to call for increased government support for R&D...it is not clear...that U.S. firms invest too little in R&D or that their returns are not competitive."

DESIGN OF AN R&D SUBSIDY

If a permanent financial incentive for private R&D were to be enacted, there clearly would be better and worse ways of structuring such an incentive. The first consideration would be whether a tax credit in any form should would be preferable to a more direct form of government grant. If one believes, as I do, that private entrepeneurs and managers are best able to make the numerous and complicated scientific and technical judgments required to ultimately transform a good idea into a commerically viable product or process, then direct government involvement should ideally be kept to a minimum. For this reason, I would agree with the testimony given by Assistant Treasury Secretary Mentz before this committee in 1987, in which he argued that there may be considerable merit in subsidizing R&D through tax credits rather than through direct government spending programs.

However, such a tax credit should be structured to satisfy three objectives. First, new, emerging firms should be at least as able to benefit from the credit, at least to the extent they have positive tax liabilities, as their larger counterparts. Second, to the maximum extent possible, the general guidelines for determining eligibility should be written to maximize the likelihood that R&D spending which qualifies for the credit has a potential for generating significant external benefits. Third, the amount of additional R&D spending stimulated per $1 of revenue loss should be as large as possible.

The R&D tax credit enacted in 1981 was deficient to varying degrees on all three points. While some new, emerging firms appear to have benefited from having a relatively low base for purposes of computing the credit, others had insufficient tax liability to claim the credit, and still others were precluded from claiming the credit because eligibility was limited to companies actively marketing products in the year they performed the research.

Prior to 1986, eligibility for the credit was determined with reference to Section 174 of the Internal Revenue Code which allowed firms considerable latitude in defining activities as R&D for purposes of claiming the credit. As a result, my own research, as well as that of others, suggests that at least in the early years of the credit, a significant portion of increased R&D spending reported for tax purposes may have reflected a reclassification of existing activities, rather than an actual increase in industrial R&D.

Finally, and most important, the base used to determine the amount of incremental spending eligible for the credit was seriously flawed in several respects. Because of the way in which the base period of the credit was defined, an additional $1 of R&D spending in the present allowed the firm to claim a tax credit, but at a cost of not being able to claim a comparable tax credit in the future because the additional $1 reduced the amount of future R&D eligible for the credit by $1. Most notably, this has had the effect of reducing the effective rate of subsidy provided by the credit. As shown by my own research as well as that of others, one consequence has been that the current credit has stimulated considerably less than $1 in additional R&D spending for each $1 of tax revenue foregone.

In addition, because the base of the credit depends on each firm's own spending on R&D, the credit has created undesirable incentives for firms to change the timing of their R&D spending in order to maximize the amount of credits that can be claimed. Firms with declining R&D spending in a given year faced an incentive to defer R&D spending to subsequent years, while other firms faced incentives to vary or to "cycle" R&D spending over a period of years, in order to be able to claim more R&D credits.

The Tax Reform of Act of 1986 significantly improved the design of the R&D credit by tightening the definition of R&D eligible for the credit to include only R&D undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in the development of a new product or process. While this change does not guarantee that all R&D spending which qualifies for the credit will generate spillover benefits, it definitely raises the likelihood that such will be the case.

However, TRA 1986 failed to address the other aforementioned deficiencies in the design of the initial credit. To a large extent, these shortcomings would be addressed by the types of changes in the structure of the credit that are proposed in S.2484.

First, S.2484 would make it possible for certain new start-up firms to claim credits for research conducted in connection with development of a future product or line of business. Second, and most important, S.2484 would scrap the existing firm-specific moving base in favor of a base that, while initially determined with reference to each firm's recent historical experience, would adjust in the future in a manner which is independent of how much each firm spends on R&D.

The gains from modifying the base in this manner are likely to be substantial. Under current law, the effective rate of the credit is such that it reduces the cost of an additional $1 of R&D to a firm which qualifies for the credit by roughly 3.4 cents. Under the types of changes proposed in S.2484, firms eligible to claim the primary credit would generally face an effective subsidy of 20 cents on each additional $1 of R&D spending, while those claiming the alternative credit would face an effective subsidy of 7 cents. Based on some empirical simulations that have been done of the effect of introducing a credit with a structure similar to that proposed in S.2484, it is highly plausible that firms would respond to such modified incentives by increasing their R&D spending by an amount that was at least equal to the amount of revenue foregone.

CONCLUSIONS

While one can make a reasonable theoretical case that private marktets may fail to allocate sufficient resources to R&D, there is relatively little strong empirical evidence about the seriousness of such potential market failures. Moreover, there are other government policies and programs which may already provide adequate support for industrial R&D or which may be superior vehicles for extending additional support.

Concerns of this sort do not mean that one should eschew providing additional financial incentives in the form of a permanent R&D credit. Rather, one should be somewhat circumspect in implementing such a policy.

For this reason, while there are clear advantages to making the credit permanent, one might also consider an alternative proposal to extend the credit, with the types of modifications in the structure of the base proposed in S.2484, for some reasonable period of time, say through 1992. However, in order for such an extension to serve as more than yet another postponment of a final decision, one should couple the extension with an explicit commitment to evaluate the performance of the revised credit, especially as compared to other policy options for supporting private R&D, such as increased funding of the National Science Foundation or of federal research laboratories. For similar reasons, there would also be merit in enacting a credit somewhat less generous than the one proposed in S.2484, though structured in an identical manner.

While one may have some reservations about making the credit permanent at the level proposed in S.2484, one should have none about the proposed changes in the general structure of the credit. Regardless of one's views on the desirability of enacting a more permanent tax incentive for R&D, these changes, especially those involving the definition of the base for purposes of computing the incremental credit, would clearly make any credit that is adopted a more effective instrument of U.S. science and technology policy.

STATEMENT OF
SENATOR ALAN CRANSTON, CHAIRMAN
SENATE COMMITTEE ON VETERANS' AFFAIRS
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEPT MANAGEMENT
COMMITTEE ON FINANCE
HEARING ON MISCELLANEOUS TAX LEGISLATION
July 12, 1988

I would like to thank the Chairman of the Subcommittee, Senator Max Baucus, for the opportunity to present this testimony on S. 2611, which was reported by the Veterans' Affairs Committee on July 6, 1988. This bill would allow the Veterans' Administration (VA) access to certain tax return information in order to verify self-reported beneficiary income for purposes of needs-based VA benefits and services.

At the outset, I would like to recognize the outstanding efforts on this issue by Senator Frank Murkowski, the Ranking Minority Member of the Veterans' Affairs Committee. I am delighted that our collaborative effort in authoring this legislation has enabled us to move it forward so quickly, and I look forward to continuing to work with him and the members of the Finance Committee to secure its prompt enactment. I note that these provisions were also included in S. 2011, our omnibus veterans benefits and services bill ordered reported on June 29.

S. 2611 arose out of a March 16, 1988, General Accounting Office report entitled "Veterans' Pensions: Verifying Income with Tax Data Can Identify Significant Payment Problems" (GAO/HRD-88-24), which had been requested by Senator Murkowski.

The GAO reviewed the records of 1.4 million 1984 VA pension recipients and found that nearly half -- 698,000 -- had income reported for them to the Internal Revenue Service (IRS) and the Social Security Administration by third-party sources. Of these, 549,000 had a total of $947 million more income on tax records than had been reported to the VA. The GAO calculated -- based on only discrepancies greater than $100 -- that the potential 1984 overpayments totalled $182.5 million paid to nearly 149,000 VA beneficiaries. The GAO further found that the VA could have identified only $25.3 million of these overpayments through its existing resources and procedures.

Other Government agencies currently are permitted access to IRS and Social Security third-party tax data for purposes of eligibility determinations for certain needs-based programs, such as Supplemental Security Income, Aid to Families with Dependent Children, and Medicaid. According to the GAO, allowing the VA access to that third-party tax data would have made possible identification of over $157.2 million in overpayments. (The Congressional Budget Office estimates that S. 2611 would achieve net savings of $674 million in the first five years of enactment.) The GAO recommended that the Congress allow the VA such access, and the VA, in its official response printed as part of the GAO report, agreed that it "needs the ability to verify wages, interest, and dividends." S. 2611 would give the VA that ability.

The VA administers several "needs-based" veterans benefits, principally non-service-connected disability pension (paid to certain war-time veterans who have attained age 65 or who have permanent and total disabilities incurred subsequent to their military service); non-service-connected survivors' pension (paid to the spouses and children of certain war-time veterans who die subsequent to their service from causes unrelated to their service); and parents' dependency and indemnity compensation (paid to the parents of individuals who die of any cause while on active duty or, if subsequent to service, as a result of a disease or disability which arose while the veteran was on active duty). Eligibility for these benefits and the monthly rates payable depend upon the total income of the beneficiary and his or her immediate family.

In addition, certain veterans with disabilities incurred while they were on active duty receive service-connected disability compensation at the 100-percent rate even though their disabilities are not severe enough to qualify for a 100-percent disability rating. Such compensation is paid when the VA determines that the service-connected disability or disabilities render the veteran unable to work on other than a sporadic or inconsistent basis (the rating awarded in such a case is referred to as an "individual-unemployability" rating).

Finally, the eligibility criteria for VA hospital, nursing home, and outpatient care include certain income criteria, and the eligibility criteria for domiciliary care include a VA determination of income and lack of adequate means of support.

In the case of applications for all of those benefits and services, eligibility determinations currently are made by the VA on the basis of income data which the beneficiary has self-reported. The only Federally-collected data which currently may be matched against VA self-reported beneficiary data to verify the latter are to Social Security payments, which clearly do not cover all forms of income.

In the case of compensation based on an individual unemployability rating, however, only the veteran's ability to earn a living is relevant; unearned income, such as dividend payments, has no bearing on this determination. Therefore, S. 2611 would limit the VA's authorization to obtain return information to earned income in such a case, and the VA would be allowed to act upon such information only when the VA Administrator determines that the earnings reported in the tax records clearly indicate that the beneficiary involved may no longer be qualified for a rating of total disability.

Mr, Chairman, I would like to emphasize that nothing in S. 2611 would eliminate or reduce the entitlement of any VA beneficiary. It would merely provide the VA with a tool, previously provided to other Government agencies, to ensure that the furnishing of certain needs-based benefits and services is in accordance with statutory requirements. Indeed, the bill would apply to the VA the strict requirements with respect to giving beneficiaries notice of any proposed reductions in payments, the basis for the proposed reduction, and an opportunity for the beneficiary to respond to the VA's proposed action (as required by section 1137(c)(2) of the Social Security Act [42 U.S.C. 1320b-7(c)(2)]), and governing the confidentiality of return information which has been disclosed (as required by section 6103(l)(7) of the Internal Revenue Code of 1986 [26 U.S.C. 6103(l)(7)(C)]) which the other Government agencies that have been given access to such information also must meet.

In addition, S. 2611 would require the VA to notify the benefits recipients and applicants potentially affected, prior to beginning any verification, that self-reported income data would be subject to verification by means of matching against information in reports submitted by employers, financial institutions, and other third parties to the Internal Revenue Service and the Social Security Administration. Subsequently, the VA would be required to provide notice of the income-verification program to all new applicants for the benefits involved or for health-care services based on income status and periodically to renotify all recipients.

The VA's administrative costs of establishing and operating the verification program, although less than 15 percent of the savings which would be produced, nevertheless would be substantial. Therefore, to ensure that the VA would not be prevented from implementing this cost-saving program because its general operating expense account already is overburdened, program costs would be paid for out of the VA's compensation and pension account, into which all program savings produced by this matching would accrue.

Mr. Chairman, the Veterans' Affairs Committee's report (S. Rept. No. 100-412) on the bill contains a full discussion of the legislative provisions we are proposing, and I commend it to the Committee's attention.

STATEMENT

OF

SENATOR TOM DASCHLE
(SOUTH DAKOTA)

Member,
Senate Committee on Finance

TESTIMONY

The proposal I am here to discuss today is one that my colleagues on the Finance Committee will recall I asked to have included in the tax title to the budget reconciliation legislation last year. The provision was subsequently dropped along with so many others as a result of the "budget summit" agreement between the Administration and the leadership of Congress, but the underlying problem remains today and is, if anything, more serious.

As the tax practitioners attending this hearing know, there are two general methods of accounting used by taxpayers: the cash method and the accrual method. The cash method recognizes income and expenses at the time cash is actually received or paid out, while the accrual method recognizes income and expenses when the claim to the income or the obligation to pay the expenses arises. Although it is said that the accrual method more accurately reflects a taxpayer's financial situation, the cash method is much simpler because bookkeeping and accounting duties are minimized.

In 1986, Congress decided that ideally all taxpayers should be on the accrual method of accounting. Congress made an exception, however, for businesses with gross receipts of $5 million or less, recognizing that businesses of that size generally do not have access to the resources and sophisticated accounting help that larger businesses do. The added tax revenues from having the small businesses on the accrual method was simply not worth the trouble to those businesses and to the

Treasury. This new limitation on the cash method of accounting was set forth in Internal Revenue Code Section 448(c).

Nowhere in Section 448(c) is it stated that small banks do not fall under the exception that allows businesses under $5 million in gross receipts to use the cash method. Yet, another provision in the Tax Reform Act of 1986 stated that a previously-enacted rule thought to apply only to acquisition discount or original issue discount on bonds and similar instruments was applicable, as well, to interest on short term loans, regardless of the taxpayer's size and regardless of whether the loan was issued at a discount. That provision is Section 1281, and its effect is to require cash basis taxpayers to recognize and pay tax on interest income on short term loans, without regard to whether the taxpayer has actually received the interest income in cash or not.

For small banks in rural areas, Section 1281 has had a severe impact. The primary source of income for these banks is short term loans to farmers. In farming, loans are needed up front in the planting season to plant crops for which no income will be recognized until many months later when the crops are harvested and sold. Because farmers generally do not have the cash flow to make regular monthly payments on a loan, rural bankers typically make loans to farmers under such terms that the farmers do not have to pay any of the principle or interest until the term of the loan expires, usually after the crops are sold.

I might add that, in a rural economy, there is a ripple effect to the seasonal nature of farm income. That is, loans to businesses and individuals that provide services to farmers are often made on similar terms.

Most important, for purposes of understanding the effect of Section 1281, is the fact that these short term loans frequently span two tax years. Section 1281 says that a pro rata portion of the interest income on the loan must be recognized and taxed in the first year, even though that income will not be received until the next year.

Because of the large number of short term loans made by small banks in rural areas, the effects of Section 1281 add up to a significant burden. Envision a small rural bank with over 50% of its business involving short term loans having to recognize and pay tax on a pro rata portion of the income on those loans in one year, when the income will not actually be received until sometime the following year. Some cash basis banks have found that the resulting tax is almost as great as their net income for the year.

An accounting firm with branches in my state, McGladrey, Hendrickson & Pullen, estimated last year that the total tax on the accelerated income for the twenty cash basis banks they prepare books for in Sioux Falls, South Dakota, would be around $3 million, or an average of $150,000 per bank.

Section 1281 places cash basis banks under a hybrid accounting scheme where they must shoulder the burden of the accrual method, while not receiving any of the corresponding benefits of the accrual method. They must recognize the income on short term loans but are not permitted, for example, to take deductions for the accrued interest expense payable on short term deposits made by their customers.

It would be easy to say that these banks should simply switch to the accrual method of accounting, in order to obtain the corresponding benefits of the accrual method. While ultimately we in Congress may decide that to be the correct result, we should make that decision expressly and facilitate the change in a fair manner.

Section 1281 is in direct contradiction to Section 448(c), which expressly states that small businesses may continue to use the cash method of accounting. Furthermore, when Section 1281 was enacted in October 1986, it was made retroactive to September 1985. The technical corrections bill that was recently introduced in the Senate and House changes that date to December 31, 1985. The provision is still unfair, however, because small banks did not have time to apply to the IRS for a change in accounting methods by the time the Tax Reform Act of 1986 was enacted. The IRS requires applications for changing one's taxable year to be submitted during the first 180 days of the taxable year in which the taxpayer wishes to switch.

Finally, there was absolutely no transition rule provided for banks affected by Section 1281. Traditionally, when Congress has enacted tax changes that have resulted in a heavy initial impact, we have always sought to make the transition fair by allowing affected taxpayers to smooth the effects of the transition. We permit them to spread the impact over several years, for example, or we provide taxpayers the opportunity to make changes that will ease the impact of the new law. That simply was not done with respect to Section 1281, and the small rural banks are suffering considerably as a result.

I should mention here, too, that it has been argued that switching to accrual would not be difficult for small bankers because they already keep accrual books for federal regulatory purposes. This is not entirely true. Bankers must keep accrual books for certain specified instruments only. A switch to the full accrual method for tax purposes would mean keeping complicated records on an array of items for which they do not currently keep detailed records as cash basis taxpayers.

Mr. Chairman, I have received many letters from small bankers across the country, who are concerned about Section 1281. I have letters from small bankers in Texas, Kansas, Oklahoma, Arkansas, Oregon, Colorado, Iowa, California, Nebraska, Florida and Illinois. This is not just a problem for small bankers in my state of South Dakota, it is a problem for small bankers everywhere. We need to assist them with a problem we in Congress have created, and we need to do it as soon as possible. Already, small bankers are struggling with their enormous tax burdens from last year. Many are confused about the provision and finding it impossible to go back and compute amounts that should have been accrued because they simply do not have the detailed records necessary to do so.

Last year, I introduced a bill, S.1239, along with my colleagues Senators Armstrong and Durenberger, to correct this problem. In simple terms, the bill repeals the application of Section 1281 to short term loans, with the result that cash basis taxpayers would not have to accrue interest on short term loans. This would make the treatment of small cash basis banks consistent with Section 448(c).

Later on at this hearing, you will hear from a small banker in my state, Charles Seaman of the First State Bank of Warner in Warner, South Dakota, a town of approximately 300 people. I hope you will listen carefully to what he has to say about the effect of Section 1281 on his bank. He has come a long way to tell you about it because alleviating the impact of the provision on his bank and others similarly situated is perhaps the most important matter to him right now.

Thank you, Mr. Chairman.

STATEMENT OF CONGRESSMAN HAL DAUB (R-NE)
BEFORE THE FINANCE TAXATION & DEBT
MANAGEMENT SUBCOMMITEE
JULY 12, 1988

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, THANK YOU FOR THE OPPORTUNITY TO TESTIFY BEFORE YOU TODAY REGARDING THE IMPOSITION OF ACCRUAL ACCOUNTING ON SHORT-TERM LOANS HELD BY BANKS. ON MAY 7TH I INTRODUCED LEGISLATION, H.R. 2323, TO ALLOW CASH BASIS BANKS TO CONTINUE TO USE THE CASH METHOD OF ACCOUNTING FOR TAX PURPOSES FOR SHORT-TERM LOANS. THE CAMPANION BILL, S. 1239, WAS INTRODUCED IN THE SENATE SHORTLY THEREAFTER.

THE 1984 DEFICIT REDUCTION ACT REQUIRED THAT ACQUISITION DISCOUNT ON SHORT-TERM OBLIGATIONS BE ACCOUNTED FOR ON THE ACCRUAL BASIS BY CASH BASIS BANKS. A "TECHNICAL AMENDMENT" TO THE 1984 ACT, INCLUDED IN THE 1986 TAX REFORM ACT, EXTENDED THE ORIGINAL ISSUE DISCOUNT RULES IN THE 1984 ACT TO INCLUDE INTEREST ON SHORT-TERM OBLIGATIONS "IRRESPECTIVE OF WHETHER THE INTEREST IS STATED OR IS IN THE FORM OF ACQUISITION DISCOUNT OR WHEN THE INTEREST IS PAID."

IT IS MY POSITION THAT THE O.I.D. RULES IN THE 1984 ACT DID NOT APPLY TO THE ACCRUAL OF INTEREST ON SHORT-TERM LOANS WHERE INTEREST WAS BASED ON A FIXED RATE AND PAYABLE AT FIXED PERIODIC INTERVALS OVER THE TERM OF THE INSTRUMENT. THE TECHNICAL CORRECTION TO THE 1984 ACT, THEREFORE, WAS NOT TECHNICAL AT ALL, BUT INSTEAD A RETROACTIVE CHANGE IN THE LAW EXPANDING SECTION 1281 OF THE CODE TO REQUIRE THE ACCRUAL OF ANY INTEREST, INCLUDING STATED INTEREST ON SHORT-TERM OBLIGATIONS, REGARDLESS OF THE TAXPAYER'S METHOD OF ACCOUNTING.

IT IS MY STRONG FEELING THAT CONGRESS, AND IN PARTICULAR MY COMMITTEE - WAYS & MEANS, INSTEAD ADDRESSED THE TREATMENT OF

CASH METHOD TAXPAYERS IN A FULLY DEBATED PROVISION OF THE 1986 TAX REFORM ACT, SECTION 801. THIS PROVISION REPEALED THE CASH METHOD OF ACCOUNTING AFTER DECEMBER 31, 1986 FOR TAXPAYERS WITH GROSS RECEIPTS IN EXCESS OF $5 MILLION. THIS PROVISION FAIRLY, AND SUFFICIENTLY ADDRESSES THE PROBLEM AND SHOULD BE CONSIDERED AS THE OVERRIDING INTENT OF CONGRESS. WITHOUT THIS INTERPRETATION OF THE LAW, THE EXEMPTION FOR SMALL BUSINESSES WITH LESS THAN $5 MILLION IN GROSS RECEIPTS RESULTS IN A MEANINGLESS EXCEPTION FOR SMALL BANKS.

IT MAKES NO SENSE TO ME TO IMPLEMENT SECTION 1281, FORCING THE RECOGNITION OF ALL INTEREST INCOME FOR ALL OBLIGATIONS OF LESS THAN 1 YEAR, WITHOUT ANY SPREAD OF THAT INCOME. THIS IS GROSSLY UNFAIR, PARTICULARLY WHEN A NORMAL CHANGE IN METHOD OF ACCOUNTING WOULD RESULT IN AT LEAST A THREE YEAR SPREAD OF THAT INCOME.

SECONDLY, THE UNFAIRNESS OF THIS RULE IS AMPLIFIED BY THE RATE STRUCTURE AND DEFERRAL RULES. WHILE CASH METHOD BANKS, IN GENERAL, ARE ALLOWED A FOUR YEAR SPREAD UNDER THE 1986 TAX REFORM ACT, THOSE BANKS AFFECTED BY THIS RULE MUST RECOGNIZE A LARGE PART OF THEIR INCOME (BUT NOT THEIR EXPENSES) IN THE FIRST YEAR THAT THE RULE APPLIES, 1986. FOR MANY BANKS IN THE MIDWEST, THESE LOANS CAN REACH UP TO 90% OF A BANK'S ENTIRE LOAN PORTFOLIO. NOT ONLY IS THERE NO RELIEF FROM THE BUNCHING OF THE INCOME, BUT THE TAX IS IMPOSED AT THE HIGHER RATES THEN IN EFFECT FOR 1986.

THIRD, LET ME POINT OUT THAT MANY OF THESE SMALL BANKS WITH LESS THAN $5 MILLION IN GROSS RECIEPTS WILL DECIDE TO CHANGE THEIR METHOD OF ACCOUNTING, SO THAT THEY CAN ACCRUE THEIR CURRENT EXPENSES AGAINST THEIR CURRENT INCOME. UNFORTUNATELY, THEY MUST MAKE THIS ELECTION WITHIN SIX MONTHS OF THE TAXABLE YEAR, MEANING 1989 AT THE EARLIEST. THE RESULT IS AN EVEN

GREATER HARDSHIP BECAUSE EXPENSES WILL BE SPREAD OUT OVER A SIX YEAR PERIOD UNDER CURRENT RULES, MEANING THAT SMALL BANKS WILL HAVE TO WAIT SIX YEARS TO REALIZE THEIR LOSSES, WHILE THEIR GAINS ALL FALL IN A SINGLE TAXABLE YEAR.

FOURTH, THIS PROVISION CAUSES A VERY BURDENSOME ACCOUNTING PROBLEM FOR THESE INSTITUTIONS. THIS IS BECAUSE BANKS DO NOT KEEP TRACK OF THEIR LOANS BASED ON THEIR DURATION, IN THIS CASE ONE YEAR OR LESS UNDER SECTION 1281. IN ORDER TO GO BACK AND AMEND THEIR RETURNS, THE ADMINISTRATIVE COSTS TO LOOK AT EVERY SINGLE LOAN WILL BE VERY EXPENSIVE.

FIFTH, MOST OF THESE SMALL BANKS HAVE A TOUGH ENOUGH TIME KEEPING UP WITH THE SWEEPING CHANGES IN THE 1986 TAX REFORM ACT. THIS LITTLE KNOWN PROVISION WILL RESULT IN EXTENSIVE PENALTIES AND INTEREST CHARGES DATING BACK TO 1985. I FIND THIS KIND OF RETROACTIVE, OBSCURE RULE WITH ACCOMPANYING PENALTIES VERY UNFAIR.

LET ME MAKE A BRIEF NOTE ON THE REVENUE EFFECTS OF THE VARIOUS OPTIONS I HAVE EXPLORED AND I'M SURE THIS COMMITTEE WILL EXPLORE. YOU WILL FIND THAT VIRTUALLY ANY OF THE POSSIBILITIES TO SOLVE THIS PROBLEM WILL BE VERY EXPENSIVE, AT LEAST THE ONES THAT MAKE GOOD POLICY SENSE. HOW A TECHNICAL CORRECTION TO THE 1984 ACT RESULTED IN SO MUCH REVENUE, I WILL NEVER UNDERSTAND. HOWEVER, IN CONVERSATIONS WITH THE TREASURY I HAVE FOUND THAT IT IS THEIR CONSENSUS THAT NONCONFORMING BANKS ARE NOT ON AN ACCEPTED METHOD OF ACCOUNTING. UNDER REVENUE PROCEDURE 84-74, IF A TAXPAYER COMES FORWARD ASKING FOR RELIEF AND TO BEGIN AN ACCEPTED METHOD OF ACCOUNTING, A THREE YEAR SPREAD WILL BE GIVEN ON THE SECTION 481 INCOME BEGINNING EITHER IN THE CURRENT YEAR OR THE FOLLOWING YEAR, DEPENDING ON CIRCUMSTANCES.

IF THIS IS INDEED THE RULE, THEN I CANNOT BELIEVE THAT MY RECOMMENDATION TO YOU TODAY WOULD TRULY RESULT IN A SUBSTANTIAL REVENUE LOSS. IT IS MY FEELING THAT TREASURY MUST ISSUE TO YOU THEIR FORMAL POSITION REGARDING THE TREATMENT OF THESE BANKS, AND THAT A NEW REVENUE ESTIMATE WILL BE NECESSARY SO THAT YOU CAN THEN RECONSIDER YOUR OPTIONS.

AGAIN, IT IS MY RECOMMENDATION TO THIS COMMITTEE TO CONSIDER SECTION 801 OF THE TAX REFORM ACT TO BE THE OVERRIDING INTENT OF CONGRESS ON THE ISSUE OF CASH ACCOUNTING. IF I CAN BE OF ANY HELP TO YOU REGARDING THIS PROBLEM, PLEASE DO NOT HESITATE TO CONTACT ME.

STATEMENT OF DANIEL J. EVANS
HEARING ON H.R. 2792
SENATE FINANCE COMMITTEE
UNITED STATES SENATE
JULY 12, 1988

MR. CHAIRMAN, I AM PLEASED TO TESTIFY IN SUPPORT OF H.R. 2792, A BILL THAT PROVIDES THAT INCOME EARNED BY INDIAN TRIBAL MEMBERS EXERCISING FISHING RIGHTS GUARANTEED BY TREATY, STATUTE, OR EXECUTIVE ORDER IS EXEMPT FROM TAXATION UNDER STATE OR FEDERAL LAW. I RECOMMEND THAT THE COMMITTEE INSTRUCT ITS STAFF TO WORK WITH THE STAFF OF THE SELECT COMMITTEE ON INDIAN AFFAIRS IN DRAFTING ITS REPORT SO THAT THE COMMITTEE REPORT REFLECTS THE WORK WHICH THE SELECT COMMITTEE HAS DEVOTED TO UNDERSTANDING THE EFFECTS OF THIS BILL ON EXISTING PRINCIPLES OF LAW AFFECTING INDIANS.

THE INTERNAL REVENUE SERVICE BEGAN LEVYING TAXES ON INCOME DERIVED FROM TREATY FISHING. THE SELECT COMMITTEE ON INDIAN AFFAIRS REPORTED OUT S.727, A BILL THAT WOULD CLARIFY THAT INCOME DERIVED FROM THE EXERCISE OF TREATY FISHING RIGHTS IS NOT SUBJECT TO TAXATION. THE ADMINISTRATION SUPPORTED A CONGRESSIONAL CLARIFICATION OF THIS ISSUE AND MADE A COMMITMENT NOT TO COMMENCE ENFORCEMENT EFFORTS WHILE CONGRESS CONSIDERED CLARIFYING LEGISLATION. THE HOUSE PARLIAMENTARIAN RULED THAT S.727 WAS A REVENUE MEASURE WHICH NECESSARILY MUST ORIGINATE IN THE HOUSE. SUBSEQUENTLY, SEVERAL CONGRESSMAN INTRODUCED H.R. 2792, A COMPANION BILL TO S.727.

H.R. 2792 DEFINES THE SCOPE OF THE TAX EXEMPT STATUS OF INCOME DERIVED FROM THE EXERCISE TREATY FISHING RIGHTS. THE BILL FURTHER ATTEMPTS TO CLARIFY THE RELATIONSHIP OF THE EXEMPTION TO TREATIES. ESSENTIALLY, I AGREE WITH THE SCOPE OF THE EXEMPTION AS DEFINED BY THE BILL. HOWEVER, MY CONCERNS ABOUT THIS BILL REST ON ITS CONSISTENCY WITH ESTABLISHED PRINCIPLES OF INDIAN TREATY CONSTRUCTION.

SECTION 1(C)(3) WHICH EXPLAINS THE RELATIONSHIP OF THE TAX EXEMPTION TO TREATIES MIGHT BE CONSTRUED AS A SIGNIFICANT DEPARTURE FROM ESTABLISHED PRINCIPLES OF THE RELATIONSHIP BETWEEN THE UNITED STATES AND THE INDIAN TRIBES. WHEN NON-INDIANS FIRST ARRIVED ON THIS CONTINENT, INDIANS FISHED FOR SUBSISTENCE, CEREMONIAL, AND COMMERCIAL PURPOSES WITH "NOT A SHADOW OF IMPEDIMENT." UNITED STATES V. WINANS, 198 U.S. 371, 381 (1905). IN TREATIES SUBSEQUENTLY NEGOTIATED BETWEEN THE UNITED STATES AND THE INDIAN NATIONS THE INDIANS RESERVED FOR THEMSELVES THEIR TRADITIONAL RIGHTS TO FISH AT THEIR USUAL AND ACCUSTOMED FISHING PLACES IN COMMON WITH ALL CITIZENS. AS THE SUPREME COURT HAS STATED, TREATIES ARE TO BE CONSTRUED "NOT AS A GRANT OF RIGHTS TO THE INDIANS, BUT A GRANT OF RIGHTS FROM THEM -- A RESERVATION OF THOSE NOT GRANTED." SEE WINANS, 198 U.S. AT 381. THUS, TO THE EXTENT THEY DID NOT RELINQUISH THEIR RIGHTS TO FISH FREE OF IMPEDIMENT, THE TRIBES STILL RETAIN THOSE RIGHTS.

THE TRIBES HAVE NEVER RELINQUISHED THEIR RIGHT TO FISH FREE OF STATE, LOCAL, OR FEDERAL TAXATION. ACCORDINGLY, STATE COURTS HAVE DEEMED INCOME DERIVED FROM THE EXERCISE OF TREATY FISHING RIGHTS TO BE FREE FROM STATE TAXATION. SEE WASHINGTON DEPT. OF FISHERIES V. DEWATTO FISH CO., 660 P.2D 298 (WASH. 1983); SEA-PAC CO., INC. V. WASHINGTON DEPT. OF FISHERIES, 638 P.2D 92 (WASH. APP. 1982). ALTHOUGH THE CONGRESS POSSESSES THE POWER TO ABROGATE TREATIES WITH THE INDIAN TRIBES, IT HAS NEVER DONE SO AS TO TAXATION OF INCOME DERIVED FROM EXERCISING THOSE TREATY RIGHTS. FURTHERMORE, SUCH POWER TO ABROGATE TREATIES IS NOT TO BE LIGHTLY IMPUTED TO THE CONGRESS AND MUST BE EXERCISED BY EXPRESS LANGUAGE. MENOMINEE TRIBE V. UNITED STATES, 391 U.S. 404, 412-413 (1968); WASHINGTON V. WASHINGTON STATE COMMERCIAL PASSENGER FISHING VESSEL ASS'N, 443 U.S. 658, 690 (1979).

THE DISPUTE BETWEEN THE DEPARTMENT OF THE INTERIOR AND THE INTERNAL REVENUE SERVICE ARISES OUT OF AN INHERENT TENSION

BETWEEN TWO APPLICABLE, LONGSTANDING CANONS OF CONSTRUCTION: FIRST, THAT, REGARDLESS OF THE CIRCUMSTANCES, EXEMPTIONS FROM FEDERAL INCOME TAXATION BE "CLEARLY EXPRESSED"; AND SECOND, THAT TREATIES AND STATUTES AFFECTING INDIANS ARE TO BE INTERPRETED LIBERALLY, IN LIGHT OF THE TRUST RESPONSIBILITY OF THE UNITED STATES AND BEARING IN MIND THE INDIANS' HISTORICALLY INFERIOR BARGAINING POSITION, WHICH CHARACTERIZED NEGOTIATION OF THEIR TREATIES. UNFORTUNATELY, THE COURTS HAVE NOT BEEN WHOLLY CONSISTENT IN DESCRIBING HOW THE BALANCE BETWEEN THESE CANONS OF CONSTRUCTION SHOULD BE STRUCK. AS A RESULT, THE INTERNAL REVENUE SERVICE CONTINUES TO PROSECUTE INDIAN FISHERMEN FOR FAILING TO PAY A TAX THAT THE INTERIOR DEPARTMENT SAYS THEY DON'T OWE. TRAGICALLY, THE INDIAN PEOPLE ARE CAUGHT IN THE MIDDLE.

THE ARGUMENT THAT AN EXEMPTION MUST DERIVE EXPLICITLY OR IMPLICITLY FROM TREATY LANGUAGE IS IN DIRECT OPPOSITION TO THESE PRINCIPLES. IT IS ILLOGICAL THAT A FEDERAL TAX EXEMPTION MUST DERIVE FROM SPECIFIC TREATY LANGUAGE WHEN SUCH TREATIES PREDATED THE FEDERAL INCOME TAX BY SEVERAL DECADES. FURTHERMORE, IF THE TREATIES CONTAIN NO LANGUAGE UPON WHICH TO CONSTRUE A SPECIFIC TAX STATUS, AND IF THE CONGRESS HAS NEVER EXPRESSLY ABROGATED IMPEDIMENT-FREE TREATY FISHING RIGHTS AS TO TAXATION, THEN THE TRIBES' RIGHT TO FISH FREE OF SUCH TAXATION WAS NOT CONCEDED TO THE UNITED STATES, BUT WAS RESERVED BY THE TRIBES.

S.727, THE BILL TWICE PASSED BY THE SENATE CLARIFYING THIS TAX STATUS, WAS CAREFULLY DRAFTED TO COMPORT WITH THESE ESTABLISHED PRINCIPLES OF INDIAN TREATY CONSTRUCTION AND CASE LAW. I AGREE THAT THE SCOPE OF THE EXEMPTION IS SUCH THAT INCOME DERIVED FROM THE EXERCISE OF PROTECTED FISHING RIGHTS IS EXEMPT ONLY TO THE EXTENT CLARIFIED IN THIS BILL. BUT I URGE THE COMMITTEE TO REVIEW CAREFULLY THIS MEASURE AND ESPECIALLY SECTION 1(C)(3), TO ENSURE THAT THEY ARE CONSISTENT WITH THESE PRINCIPLES AND THAT THE BILL DOES NOT ABROGATE RESERVED TREATY RIGHTS.

MR. CHAIRMAN, I AM GRATEFUL FOR THIS OPPORTUNITY TO TESTIFY IN SUPPORT OF H.R. 2792. I URGE THE COMMITTEE TO ACT ON THIS IMPORTANT LEGISLATION EXPEDITIOUSLY.

STATEMENT OF SUZAN SHOWN HARJO, EXECUTIVE DIRECTOR, NATIONAL CONGRESS OF AMERICAN INDIANS, ON H.R. 2792, BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE, UNITED STATES SENATE, IN THE HEARING ON MISCELLANEOUS TAX PROVISIONS, JULY 12, 1988, WASHINGTON, D.C.

Mr. Chairman and Members of the Subcommittee, thank you for according the opportunity to present this statement on behalf of the membership of the National Congress of American Indians, the leading national intertribal organization established in 1944 to advocate the inherent sovereign, treaty and other legal rights of American Indian nations and people.

We support all efforts of Congress to clarify for the Internal Revenue Service and the Department of Justice that income derived by tribal citizens from the exercise of fishing rights guaranteed or affirmed by treaty, Executive order, statute or caselaw is not taxable by the federal or state governments under U.S. or international law.

The Internal Revenue Service, with the support of the Department of Justice, but with the opposition of the Department of the Interior, is wrongly challenging the non-taxable status of Indian treaty fishing rights in the Pacific Northwest and the Great Lakes areas.

The appropriate Indian policy Committees of Congress for clarification of this matter - the Senate Select Committee on Indian Affairs and the House Committee on Interior and Insular Affairs - have concluded that the position of the IRS and Justice is incorrect and that the position of the Interior and of the Indian governments is correct. The House Committee on Ways and Means also came to this conclusion, and we are confident that your Subcommittee will reaffirm the conclusions and principles contained in the clarification bill, S. 727, passed by the Senate in June of last year. The policy context for the bill we have supported is contained in the attached letter of April 7, 1987, to the Senate Select Committee on Indian Affairs.

In the House of Representatives, legislation on this matter became a revenue measure. To the extent that it accomplishes the same result as the Senate-passed S. 727 to protect Indian fishing rights, and to the extent that your Subcommittee will act to forestall erosion of these or any other Indian rights, we support H.R. 2792. If our concern can be addressed in report language and this bill enacted as a free-standing measure, we support the speedy discharge of H.R. 2792. If, however, the bill is to be made a part of the technical corrections legislation, and therely subject to further procedural and substantive steps and opportunities, we would support additional changes, especially in the Ways and Means provisions which draw lines between tribes and complicate the calculation of fishery income along tribal lines, rather than in accordance with treaties.

We are deeply concerned that this measure, without additional clarifying report language, would jeopardize the treaty rights of Indian governments and tribal citizens and would be the harbinger of generations of litigation and expense to all thoses who are intended to be protected by H.R. 2792.

Specifically, we urge the Subcommittee to clarify that this measure is not the source of the exclusion from tax and that H.R. 2792 does not imply that any other Indian treaty right is subject to tax. We support the proposed solution of the Chairman of the Select Committee on Indian Affairs in this regard, in order to expedite approval of this legislation without returning it to the House Committee on Ways and Means. If, however, the instant course is not followed, we would prefer that the present Subsection 3 be deleted as a confusing and potentially complicating provision.

Thank you for your serious consideration of our concerns, expressed especially on behalf of the Indian nations who have treaties which cannot be unilaterally abrogated without constitutional compensation under known law. Such an abrogation would be wrong as a matter of U.S. policy and morality. For those viewing this as a revenue measure, it should be pointed out that such abrogation would cost the federal government in the trillions of dollars, according to past Congressional estimates.

These matters are not all that complex, but they can be confusing, as the President demonstrated so very publicly a few weeks ago to the world community of nations. For the information of the Subcommittee, a copy of my response to those misguided statements is provided with this testimony (reprint, The Miami Herald, page 1, Viewpoint, June 5, 1988).

Dear Mr. Chairman:

On behalf of the membership of the National Congress of American Indians, I am pleased to commend you and the other sponsors of S. 727, the Indian Fishing Rights Act. We urge its speedy enactment.

The American Indian and Alaska Native governments and people who comprise the voting membership of NCAI support this effort to clarify the law, for the edification of the Internal Revenue Service and the Justice Department, and to reaffirm that Indian fishery income is free from taxation. This will have been an expensive lesson, but not for the federal agencies. It is the Indian peoples who are paying for the education of those who would separate us from our property, despite long-standing treaties, caselaw, executive orders, administrative decisions and statutes to the contrary. Enactment of S. 727, however, will avoid the far greater costs of protracted litigation that would take place without it. For those Lummi fishermen and their families who have been driven to financial and emotional ruin by the Internal Revenue Service and Justice Department, the costs cannot be measured.

To us, this is a plain matter. The Indian nations of the Pacific Northwest always have depended upon the salmon and other fish for religious purposes, for good health, for food, for clanship and kinship structures, for trade and for survival. They, like Indian peoples from throughout this land, gave the United States great wealth and property, and reserved precious little for themselves. Any attempt from any federal quarter to take more from the Lummi or other Indian or Native people should be rebuffed for its cupidity.

In this matter, the two federal agencies have become bureaus of revisionist history in an effort to break bargains and sidestep the U.S. Constitution. It is fitting that this effort will be rejected by Congress in the year of the bicentennial of the Constitution. These Indian peoples are the "Indians not taxed" of the Constitution. These are the peoples who ceded so much territory in order to secure a future and to maintain their traditional ways that they were "taxed" in perpetuity. They have withstood the onslaught of foreign settlement, of poisoned environments, of modern litigious warfare. They have drawn a firm line against further encroachment, and they are supported by fair-minded people everywhere.

Contrary to the views of the two federal agencies, the Indian Citizenship Act of 1924 was intended to confer benefits, not burdens, of U.S. citizenry in recognition of the service of Native people in World War I. This was to complement, not to take away, the citizenry of Indian people in their Indian nations. Persons can renounce citizenry in Indian nations; can enjoy dual citizenry in Indian nations and the U.S.; or can recognize only their Indian national citizenry. No act, nor U.S. constitutional amendment for that matter, can extinguish Indian national citizenry. And, no federal agency, nor single act, can tax the "Indians not taxed" without a constitutional amendment.

This is the way in which we understand the bill that you will mark up tomorrow, and we have only praise for your undertaking. We request that this letter become part of the record of the hearing on S. 727. Again, our deep appreciation to you and the other sponsors for being our advocate.

Sincerely,

Suzan Shown Harjo
Executive Director
National Congress of
American Indians

AMERICAN INDIANS

TARGET OF NEGLECT

By SUZAN SHOWN HARJO

Even if President Reagan had not ended his seven-year silence on American Indian issues by belittling Indian people, he would have had the worst Indian policy record of any administration in this century. Now, he also has the distinction of being the first president since the 1800s to have added insult to injury by personally offending Indian people in an international forum.

The president seemed to have been caught off guard on Tuesday by a Moscow State University student's question about his intention to meet with Indian people who followed him to Russia because he would not meet with them at home. He left the misimpression that he has an open-door policy of meeting with Indian people, even though he has either declined or ignored more than a thousand requests to meet with Indian leaders over the two terms of his administration.

After lecturing the Soviets on human rights and cultural and religious liberty, the president demeaned Indian traditions, cultures and religions as "primitive life-styles." He said the United States has "done everything we can to meet their demands as to how they want to live. Maybe we made a mistake. Maybe we should not have humored them in that, wanting to stay in that kind of primitive life-style. Maybe we should have said, 'No, come join us; be citizens along with the rest of us.' And I'm very pleased to meet with them, talk with them at any time and see what their grievances are."

The president lurched through an impressionistic, old-time-movie version of history, complete with a great-white-father image of a benign U.S. government that "provided millions of acres of land for reservations" and gave Indians a Bureau of Indian Affairs (BIA) "to help take care of them." The president appeared unaware that the United States did not have millions of acres to give away. Indian nations ceded vast territory to the United States through treaties of peace and friendship, and reserved land and other property and rights for their future generations. This is why most Indian lands are called "reservations," a word the president had a hard time recalling, dredging up instead the word "preservations," as in human zoos.

In treaty-making, Indian nations usually were not at a disadvantage, and the fledgling United States was not often in a position to humor them. For example, in a treaty with the Oneida Nation, which had fed Gen. George Washington and his troops at Valley Forge, the U.S. salutation was, "Hail to the Victorious Allies in the Revolution." The treaties, including federal-tribal treaties, are characterized in the U.S. Constitution as the "Supreme Law of the Land," and are in full force and effect today.

In exchange for lands over which to govern, the United States promised to protect Indian territory and to respect tribal sovereignty and territorial jurisdiction. President Washington traveled to the Seneca Nation to explain in person the first Indian law passed by Congress in 1790, pledging that the new general government would not let the Indian nations be defrauded of their land by states and

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Suzan Shown Harjo, executive director of the National Congress of American Indians in Washington, is Cheyenne and Creek and a citizen of the Cheyenne and Arapaho Tribes of Oklahoma. She wrote this article for The Herald.

INDIANS / *from IC*

private interests.

The United States promised to "make the deserts bloom" for tribes that agreed to move to arid lands. The United States agreed to provide health, education and other services to Indian people, also in perpetuity. In 1983, President Reagan signed an Indian policy statement upholding these same principles, re-emphasizing the U.S. policy of government-to-government dealings with Indian nations. However fine the rhetoric of his statement, President Reagan's administration continued to undermine Indian rights, to ask Congress to cut one-third of the federal Indian budget and to take actions contrary to stated policy. This followed the pattern of the 1800s, when the United States reneged on virtually every treaty commitment once it acquired a country and its riches. The United States looked the other way while its citizenry stole the gold from the Black Hills, took over or destroyed much of the remaining Indian resources and prevented Indian people from exercising their off-reservation hunting, fishing and gathering rights.

As part of the westward expansion and a policy of Indian extermination, the U.S. Army delivered smallpox-infested blankets to some Indian nations, whose people were decimated or no longer exist. The Army force-marched many Indian nations from their homes to military outposts thousands of miles away. Under direct orders from the Army surgeon general, military officers decapitated Indian people and exhumed freshly buried bodies, weighed their brains and measured their skulls as part of a federal "Indian crania study." Over 4,500 of these skulls and volumes of reports documenting their names, tribes and family information are in the collection of the Smithsonian Institution, which boasts more than 19,000 Native human remains and displays some of them today alongside the dinosaurs and insects.

The United States set up the BIA, first in the War Department, then in the Interior Department with the flora and fauna, which helped to "take care" of Indians by ordering the BIA agents to stop all traditional Indian religious practices and to give various Christian denominations franchises on specified Indian nations. The BIA furthered the "arts of civilization" in boarding schools by beating Indian children who spoke their own languages rather than English. The BIA became the one-stop shopping center for one-cent sales of Indian property, and federal Indian agents retired in splendor while the Indian people suffered in poverty.

Reagan excerpts

On Tuesday President Reagan answered a question from a student at Moscow State University about his intention to meet with American Indians who had followed him to the Soviet Union. Here are excerpts of his comments:

The United States, the president said, has "done everything we can to meet their demands as to how they want to live. Maybe we made a mistake. Maybe we should not have humored them in that, wanting to stay in that kind of primitive life-style. Maybe we should have said, 'No, come join us; be citizens along with the rest of us.' And I'm very pleased to meet with them, talk with them at any time and see what their grievances are. . . .

"And you'd be surprised. Some of them became very wealthy because some of those reservations were overlaying great pools of oil, and you can get very rich pumping oil. And, so I don't know what their complaint might be."

In the early 1900s, when the Indian population was down to 250,000, prominent artists, scientists and church leaders began to call on the federal government to adopt enlightened policies to help Indian people to survive. In recognition of the many Indian soldiers who fought with the United States in World War I, a law was passed to make U.S. citizens of Indian nations' citizens, and federal law today recognizes Indian people as having dual citizenship. President Reagan's remarks in Moscow, delivered two days before the 64th anniversary of the Indian Citizenship Act of June 2, 1924, revealed a misconception of this history, too.

Steady progress in cultural, social and governmental rights was made in Indian country — especially through the legal clarifications and programs of President Roosevelt's New Deal administration — until the 1950s era of the federal termination policy. This era involved an assimilation policy to end the federal-tribal ties, liquidate tribal property, pay Indian people a relatively small amount of cash and to send them sailing down the mainstream of American society. Indian social and health conditions plunged, while non-Indian lawyers, bankers and land barons became millionaires. The termination experiment was halted in the 1960s and repudiated by every Congress and president since that time. President Reagan's 1983 policy also denounced termination, but his remarks to the Soviet students suggested that mainstreaming was the preferred course.

The programs of the 1960s and 1970s were designed in coordination with Indian leaders, and the controlling powers of the BIA were diminished through a score of reform acts. Even though Indian people remained at the bottom of every socioeconomic indicator, dramatic improvements were being made by 1980, when the Indian population had grown to 1.5 million.

This progress was abruptly halted and the positive trend reversed by the Reagan administration's nationwide economic experiment, which hit Indian country disproportionately. While the full extent of his proposed cuts in Indian programs were rejected by Congress, significant erosion has taken place since 1981, and several of the reform acts were gutted through the budget process and BIA fiat. Tribal educators and program professionals were turned into crisis managers who had to fight for status-quo funding at best and then perform their real jobs with fewer resources. Many tribal leaders were forced into program manager positions, in order to attempt to meet the pressing needs of their people, while being blamed by the tribal voters for the decreasing level of federal services.

The BIA has been given a free hand by this White House and is more repressive and less respectful of tribal rights and people than at any time in this century. The BIA has resumed its interference in tribal political elections, primarily by releasing or withholding programs in an effort to influence voters, and then has widely criticized tribal governments for leadership instability. Since 1986 most Indian leaders have called for the removal of Ross O. Swimmer, assistant secretary for Indian affairs who heads the BIA, but the White House has simply referred tribal complaints back to him.

In 1987, Congress became so put out by the zeal of the administration to change federal Indian policy through the budget process that it stopped all plans of the BIA to do anything new until and unless it had consulted with Indian tribes and Congress. As a result of last year's award-winning series by The Arizona Republic, "Fraud in Indian Country: A Billion-Dollar Betrayal," about the excesses of the BIA in this decade, the U.S. Senate Select Committee on Indian Affairs established a special investigations committee with a budget of nearly a million dollars for the first year.

President Reagan's administration has attempted to eliminate all Indian housing programs, when federal studies show Indian housing conditions as the worst in the nation. President Reagan vetoed the reauthorization of the Indian Health Care Improvement Act and tried to cut out all tribal hospital construction monies and urban Indian health programs, when Indian people have the poorest health status of any U.S. population and suffer from diseases virtually eradicated in the general population. Indian jobs, training and economic development programs have been under attack since the first of this administration's budget proposals, while Indian unemployment has doubled and tripled since 1980. Unemployment in Indian country was 39 percent in 1979. Today, the jobless rate on most reservations is between 50 percent and 90 percent, and the BIA's own study of three years ago showed unemployment on the 10 largest reservations averaging 75 percent. While Indian people have an average eighth-grade attainment level, the lowest nationwide, the BIA has made it harder for Indian students to get in and stay in schools, and has tried to blame the tribes for the Indian children scoring low on standardized tests.

American Indians and Alaska Natives are the poorest people in the richest country in the world. Indian people have the lowest per-capita income, the shortest lives, the highest suicide rate in the United States. Yet, President Reagan in Moscow chose to raise the specter of resource-rich Indians. "And you'd be surprised," he said. "Some of them became very wealthy because some of those reservations were overlaying great pools of oil, and you can get very rich pumping oil. And, so I don't know what their complaint might be."

Most Indian people cannot get jobs pumping gas, let alone rich pumping oil. Perhaps if the president had met with Indian leaders or paid even one call on one Indian nation, he would have understood a complaint or two and used his office for good. Even now, the president could better his record by meeting Indian leaders, by visiting in Indian country, by making an informed statement, by signing Indian health, education, economic and cultural bills into law. As Suquamish Chief Seattle said, "We may be brothers after all. We shall see."

STATEMENT OF DANIEL K. INOUYE

BEFORE THE
SENATE COMMITTEE ON FINANCE
ON H.R. 2792
TAX TREATMENT OF INDIAN FISHING RIGHTS INCOME

MR. CHAIRMAN, I AM VERY PLEASED TO TESTIFY IN SUPPORT OF H.R. 2792, A BILL THAT PROVIDES THAT INCOME EARNED BY INDIAN TRIBAL MEMBERS EXERCISING FISHING RIGHTS GUARANTEED BY TREATY STATUTE OR EXECUTIVE ORDER IS NOT TAXABLE UNDER STATE OR FEDERAL LAW.

AS I AM SURE YOU ARE AWARE, THE SELECT COMMITTEE ON INDIAN AFFAIRS REPORTED OUT S. 727, A BILL THAT WOULD CLARIFY THAT INDIAN TREATY FISHING INCOME SHOULD NOT BE SUBJECTED TO TAXATION BY ADDING AN AMENDMENT TO AN 1877 STATUTE THAT PERTAINED TO TREATY MAKING WITH INDIAN TRIBES. IT WAS THE POSITION OF OUR COMMITTEE THAT THE 1982 DECISION OF THE INTERNAL REVENUE SERVICE TO BEGIN LEVYING TAXES ON SUCH INCOME WAS IN CONFLICT WITH BASIC PRINCIPLES OF FEDERAL INDIAN LAW.

DURING THE INDIAN AFFAIRS COMMITTEE'S HEARING ON THIS BILL, THE ADMINISTRATION EXPRESSED SUPPORT FOR A CONGRESSIONAL CLARIFICATION OF THIS ISSUE AND MADE A COMMITMENT THAT THE TAXATION EFFORTS WOULD BE HELD IN ABEYANCE WHILE CONGRESS PROCEEDED TO CONSIDER LEGISLATION ON THIS MATTER.

MR. CHAIRMAN, I DO NOT NEED TO TAKE UP THE TIME OF THIS COMMITTEE DISCUSSING THE QUESTION OF WHETHER THIS IS A REVENUE MEASURE OR AN INDIAN TREATY CLARIFICATION BILL. SUFFICE IT TO SAY, THAT OUR COMMITTEE CONSIDERED IT THE LATTER WHILE THE HOUSE PARLIAMENTARIAN CONSIDERED IT THE FORMER. CONSEQUENTLY, WHEN OUR BILL, (S. 727), WAS PASSED BY THE SENATE AND REFERRED TO THE HOUSE, IT WAS NOT REFERRED TO COMMITTEE BUT WAS BLUE-LINED BY THE PARLIAMENTARIAN BASED ON HIS OPINION THAT THIS ACT REPRESENTED A REVENUE MEASURE WHICH NECESSARILY MUST ORIGINATE IN THE HOUSE. SUBSEQUENTLY, CONGRESSMEN LOWRY, UDALL AND OTHERS, INTRODUCED A COMPANION MEASURE TO OUR SENATE BILL, H.R. 2792, AND THAT BILL

WAS REFERRED TO BOTH THE INTERIOR AND WAYS AND MEANS COMMITTEES.

OUR COLLEAGUE, CONGRESSMAN RANGEL, AGREED TO HOLD HEARINGS AFTER H.R. 2792 WAS FAVORABLY REPORTED BY THE INTERIOR COMMITTEE AND ON JUNE 15, 1988, THE BILL WAS PASSED BY THE HOUSE INTERIOR COMMITTEE HAVING BEEN AMENDED AND SUBSEQUENTLY APPROVED BY THE WAYS AND MEANS COMMITTEE. AS YOU CAN SEE, THE WAYS AND MEANS COMMITTEE HAS REPORTED OUT AN AMENDMENT IN THE NATURE OF A SUBSTITUTE WHICH SPECIFICALLY EXEMPTS INDIAN FISHING INCOME FROM FEDERAL INCOME AND SELF-EMPLOYMENT TAXES, AND FURTHER PROVIDES THAT SO LONG AS SUCH INCOME IS EXEMPT FROM FEDERAL TAX, IT SHALL BE EXEMPT FROM ANY INCOME TAX BY A STATE OR POLITICAL SUBDIVISION THEREOF.

MR. CHAIRMAN, ALTHOUGH I AM OF THE OPINION THAT THE BILL ADOPTED BY THE INDIAN AFFAIRS COMMITTEE, AND APPROVED BY THE SENATE IN 1987, PROVIDES SUFFICIENT LEGISLATIVE CLARIFICATION ON THE ISSUE OF INDIAN TREATY RIGHTS TAX EXEMPTION, I AM MORE THAN HAPPY TO DEFER TO THE DECISION BY THE WAYS AND MEANS COMMITTEE TO SPECIFICALLY AMEND THE INTERNAL REVENUE CODE TO ACCOMPLISH THIS SAME OBJECTIVE. THE WAYS AND MEANS COMMITTEE SUBSTITUTE ON H.R. 2792 HAS THE ADVANTAGE OF DEFINING WHO IS QUALIFIED TO CLAIM THE EXEMPTION AND WHAT TYPE OF ACTIVITY IS COVERED BY THE EXEMPTION.

MY ONLY RESERVATION REGARDING THE WAYS AND MEANS COMMITTEE SUBSTITUTE AMENDMENT PERTAINS TO SUBSECTION (C), "SPECIAL RULES" SUBSECTION (3) RELATIONSHIP OF THIS SECTION TO TREATIES, ETC." I INTERPRET THE PURPOSES OF THIS SECTION TO BE SIMPLY A CLARIFICATION THAT NO OTHER TYPE OF TAX EXEMPTION CAN BE CLAIMED FOR INDIAN TREATY FISHING INCOME, EXCEPT AS PROVIDED FOR IN THIS BILL. THIS SECTION REPRESENTS A STANDARD METHOD OF CLARIFYING WHAT IS AND WHAT IS NOT THE LAW WITH RESPECT TO THIS MATTER. IN EFFECT, THE COMMITTEE IS SAYING NOW THAT CONGRESS HAS SPOKEN ON THIS QUESTION OF TAX TREATMENT OF INDIAN FISHING RIGHTS INCOME, THAT THIS IS THE DEFINITIVE STATEMENT, AND THAT WE, THE CONGRESS, DO NOT INTEND TO LEAVE THE DOOR OPEN FOR ADDITIONAL CLAIMS IN THE FUTURE WHICH MAY WELL END UP IN PROTRACTED LITIGATION AND CONTINUED UNCERTAINTY AND CONFUSION AS TO WHAT THE LAW IS.

SINCE THE TAX EXEMPTION AS DEFINED BY THE BILL, H.R. 2792, IS A SIMPLE STRAIGHT-FORWARD AND FAIR STATEMENT, I AM ENTIRELY IN SUPPORT OF SUBSECTION 3, AND ITS PURPOSE OF PROVIDING A CLEAR STATEMENT THAT THIS LEGISLATIVE DEFINITION OF THE EXEMPTION IS THE EXCLUSIVE DEFINITION. IN THE COMMITTEE'S REPORT ON H.R. 2792, A STATEMENT IS MADE THAT THIS BILL,

> "GOVERNS ONLY THE TAX TREATMENT OF INCOME DERIVED FROM THE EXERCISE OF FISHING RIGHTS GUARANTEED BY TREATIES, FEDERAL STATUTES AND EXECUTIVE ORDERS AND NO INFERENCE IS MADE THAT INCOME DERIVED FROM ANY OTHER ACTIVITIES GUARANTEED BY TREATIES, FEDERAL STATUTES OR EXECUTIVE ORDERS (E.G., HUNTING, GATHERINGS, OR GRAZING ACTIVITIES) IS EXEMPT FROM TAXATION."

I THINK IT IS VERY IMPORTANT THAT THIS COMMITTEE, IN ITS REPORT ON THIS SECTION OF THE BILL, ALSO CLARIFY THAT NO INFERENCE IS MADE THAT SUCH OTHER ACTIVITIES ARE NOT EXEMPT FROM TAXATION. THE LAW IS WELL ESTABLISHED THAT THESE ACTIVITIES ARE NOT TAXED AT PRESENT PRECISELY BECAUSE THEY ARE RIGHTS THAT WERE PRESERVED TO THE INDIANS BY THEMSELVES IN TREATIES AS RECOGNIZED BY FEDERAL STATUTE AND EXECUTIVE ORDERS AND THESE RESERVED RIGHTS ARE NOT TO BE BURDENED BY THE IMPOSITION OF FEDERAL AND STATE INCOME TAXES. THIS BASIC PRINCIPLE OF FEDERAL INDIAN LAW IS NOT DISTURBED OR MODIFIED IN ANY WAY BY H.R. 2792.

MR. CHAIRMAN, APART FROM THIS IMPORTANT MATTER OF CLARIFICATION WITH RESPECT TO INTERPRETATION OF SUBSECTION 3, OF H.R. 2792, I URGE YOU AND YOUR COLLEAGUES ON THE FINANCE COMMITTEE TO REPORT THIS BILL EXPEDITIOUSLY AND WITHOUT AMENDMENT. AS YOU WELL KNOW, IF THE SENATE MAKES NO AMENDMENT TO H.R. 2792, THE BILL CAN BE SENT DIRECTLY TO THE PRESIDENT FOR HIS SIGNATURE. INDIAN PEOPLE ACROSS THE COUNTRY HAVE REPEATEDLY TOLD ME AND THE MEMBERS OF MY COMMITTEE, THAT THIS BILL IS OF THE HIGHEST PRIORITY AND EXPEDITIOUS ACTION BY THIS COMMITTEE WOULD BE GREATLY APPRECIATED.

I UNDERSTAND THAT SOME MEMBERS OF THIS COMMITTEE HAVE A CONCERN THAT IF THE BILL IS PRESENTED TO THE SENATE, STANDING ALONE, IT MAY BE THE SUBJECT OF NON-RELEVANT AMENDMENTS, OR AMENDMENTS THAT PROVIDE FOR TAX TREATMENT OF OTHER TYPES OF INCOME BY NON-INDIANS. HOWEVER, I AM CONFIDENT THAT BETWEEN THE FINANCE COMMITTEE AND THE INDIAN AFFAIRS COMMITTEE, WE CAN SECURE A COMMITMENT FROM THE SENATE LEADERSHIP TO SEND THIS BILL TO THE PRESIDENT WITHOUT ANY AMENDMENT WHATSOEVER.

THANK YOU FOR YOUR GRACIOUS INVITATION TO TESTIFY AND PLEASE BE ASSURED THAT I AND MY COLLEAGUES ON THE SELECT COMMITTEE ON INDIAN AFFAIRS, ARE PREPARED TO ASSIST YOU IN ANY WAY POSSIBLE TO EXPEDITE ACTION ON THIS BILL.

TESTIMONY OF GERALD I. JAMES
VICE CHAIRMAN
LUMMI INDIAN BUSINESS COUNCIL
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE HEARING
ON MISCELLANEOUS TAX PROVISIONS

JUNE 12, 1988

I am Gerald James, Vice Chairman of the Lummi Indian Business Council, and also a Tribal fisherman. I serve as a Commissioner with the Northwest Indian Fish Commission which represents the twenty Western Washington tribes situated along the coastline of Puget Sound and the Pacific Ocean. Thirty-five of our tribal fishermen have been processed through the U.S. Tax Court because of their refusal to pay federal income taxes on treaty-protected fishing income. All have IRS collection actions pending against them. I believe my testimony will offer definite insight regarding H.R. 2792 "Indian Fishing Rights Clarifications" legislation under consideration.

We are here before you because the IRS, an administrative arm of the United States, has been attempting since 1982 to impose Federal taxes on Tribal fishermen's income derived from commercial harvest of salmon in treaty-designated waters. We appear because the IRS Chief Counsel took the position that our fishing income should be tax exempt only if exemption language was contained in our treaty. This makes no sense, since our Treaty of Point

Elliot was signed in 1855 and the first Constitutional Federal income tax law was signed in 1913. Two Interior Department Solicitors (Coldiron 1983 and Richardson 1985), who are experts in Indian law, held that our Treaty-based fishing rights are tax exempt. But the Justice Department Associate Attorney General reasoned that the Treasury Department position was the "sounder view of the law" in December, 1985. Senator Bradley and thirty-two bi-partisan Senate co-sponsors asked the Justice Department in July 1986 to "reverse their ill-conceived policy without delay." The Justice Department responded that this was a matter for Congress or the Courts to decide. Thus, we appear before you today on this significant treaty issue.

In the Pacific Northwest, fishing has been an integral element of our Tribal cultures and economies for many centuries. In the mid-1850's, Governor Stevens negotiated treaties with our forefathers whereby vast areas of land and natural resources of incalculable value were ceded to the United States in exchange for reservation lands, support provisions, and protection from non-Indian encroachments. We kept our fishing rights. Each of our treaties:

Treaty of Medicine Creek, December 26, 1854
Treaty of Point Elliott, January 22, 1855
Treaty of Point No Point, January 26, 1855
Treaty of Neah Bay, January 31, 1855
Treaty of Olympia, July 1, 1855 and
  January 25, 1856

contained the language: "The right of taking fish at usual and accustomed grounds and stations is further secured to said Indians, in common with all citizens of the Territory..." This Tribally reserved treaty right was specifically mentioned in each treaty to ensure commercial, ceremonial, and subsistence fishing rights for our future generations.

Preserving and protecting our tribal fishing rights against non-Indian encroachment and diminishment has unfortunately been a continuing struggle for each succeeding Tribal generation. Seven times in this century we have defended our Tribal fishing rights in the Supreme Court. Five times in the last decade we have fought legislative attempts to diminish or extinguish our fishing rights. Environmental degradation, mismanagement of the salmon resource, and unregulated international interception of our salmon in this century further depleted this Tribal resource.

We are heartened that H.R. 2792 has reached the Senate Finance Committee, that a hearing has been expeditiously held, and that this treaty clarification measure could feasibly become law in the 100th Congress. S. 727, a bill "to clarify Indian Treaties and Executive Orders with respect to fishing rights" as reported by the Senate Select Committee on Indian Affairs passed the Senate on May 13, 1987. A companion measure with bi-partisan support was introduced in the House in June 1987 and was jointly referred to the Committee on Interior and Insular Affairs and the Committee on Ways and Means. The Committee on Interior and Insular Affairs favorably reported H.R. 2792 on September 21, 1987; the Committee on Ways and Means favorably reported this bill, amended to conform with the Internal Revenue Code, on June 9, 1988. Even though these years have been spent to clarify that Tribal fishing rights protected by treaty are tax exempt, the Ways and Means Committee judged S. 727 unconstitutional as a revenue measure. The House of Representatives under suspension of the rules passed H.R. 2792 on June 20, 1988.

OUR TREATIES SHOULD NOT BE LIMITED OR DIMINISHED BY THIS BILL

We hope that H.R. 2792 will become law and do not want to impede its progress. We are concerned, however, that the Committee on Ways and Means in the redrafting process has implied that this legislation rather than the Treaty is the source of the tax exemption. We hope the Senate Finance Committee in its deliberations would clarify this matter. Our concern is focused on the statute Section (1)(c)(3) of H.R. 2792 and the corresponding report language.

This section poses significant threats to the body of Indian Law as developed by the Federal Courts. Indian Treaties have been judicially construed as grants from the Indians to the United States, and not grants from the United States to the Tribes. The Tribes reserved all the rights that were not given to the federal government. This 'Reserved Rights Doctrine' is a cornerstone of Indian Treaty Law.

The language of the House Bill regarding the relationship of this act to Treaties may be seen as changing the reserved rights doctrine. This is very dangerous, and could lead to substantial and expensive litigation.

The Reserved Rights Doctrine is a bedrock principle of both Indian Law and water rights law. It comes from two Indian cases which were decided over 80 years ago by the Supreme Court, United States v. Winans, 198 U.S. 371 (1903) Winters v. United States, 207 U.S. 564 (1908). The Winans case involved interpretation of the Treaty Fishing Rights of the Pacific Northwest Indians, in particular, the Yakima Nation. The Supreme Court held that the fishing rights recited in the Treaty were not a gift from the United States, but were reserved by the Indians. As the Court said, "In other words, the treaty was not a grant of rights to the Indians, but a grant of rights from them, - a reservation of those not granted." In the Winters case the Supreme Court held that the reservation of rights to a reservation in the Indian Treaty included by implication enough water to make the land productive; this reserved right to water defeated a non-Indian claim to water rights later granted by the State or the United States. The Winters holding is routinely used to justify federal water and use rights reserved by implication to the federal government in national forests, national monuments, and national parks, as well as upon Indian reservations. The Reserved Rights Doctrine has been upheld by the Supreme Court and the lower federal courts in countless cases.

Indian Tribes are governments within the federal system. Many laws - Indian Tribal Governmental Tax Status Act, Clean Water Act, Clean Air Act, now-defunct Revenue Sharing, etc. - recognize and confirm this long-standing judicial characterization. The Executive Branch cooperates with the Tribes as governments, acknowledging that such status derives from the Treaties with the Tribes. However, State governments traditionally are very antagonistic to treaty derived powers.

The 'relationship to treaties' language in the Bill permits the States once again to advance the argument that Indian Treaty rights are only a gift from Congress, and do not come from the solemn national commitments represented by the Treaties. The States routinely and vigorously fight any assertion of treaty rights by Indians. Perhaps the most bitterly fought issues in the Pacific Northwest concern the fishing rights which this Bill interprets. As the Supreme Court stated in its 1979 decision interpreting the Fishing Rights clause of the Pacific Northwest Treaties:

> The impact of illegal regulation, see Tulee v. Washington, 315 U.S. 681, 86 L.Ed. 1115, 62 S. Ct. 862, and of illegal exclusionary tactics by non-Indians, see United States v. Winans, 198 U.S. 371, 49 L.Ed. 1089, 25 S.Ct. 662, in large measure accounts for the decline of the Indian fisheries during this century and renders that decline irrelevant to a determination of the fishing rights the Indians assumed they were securing by initialing the treaties in the middle of the last century.

Washington v. Washington Commercial Passenger Fishing Vessel Ass'n., 443 U.S. 658, (1979), at 669, n.14.

Despite the language in the House Report limiting the section's effect to federal taxes, State Attorneys General are certain to seize upon the 'relationship to treaties' language to initiate another round of attacks on the Reserved Rights doctrine. They will claim that treaty rights are neither enforceable nor self-executing without Congressional action such as this language. Although a similar argument was rejected by the Supreme Court in Fishing Vessel at 443 U.S. 693, n.33, the States will claim that this legislation modifies that holding. New litigation asserting this old claim can be expected, for the States have proven that they are nothing if not inventive when it comes to attacking Indian treaties.

Modification of the this language to provide that the protections of this act are coextensive with the treaty is appropriate and will forestall State action. We recommend this language:

> **The provisions of any law, Executive Order, or treaty which secure any fishing right for any Indian Tribe shall not be construed to provide an exemption from any tax imposed by this title which is any broader than the exemption recognized by this section.**

We suggest that corresponding report language should be:

> **This Bill is consistent with Congress's interpretation of the scope of tax immunity with respect to Indian fishing activity under existing Treaties, Executive Orders and Federal statutes. It is not intended to expand or limit such rights. Accordingly, the Bill provides that provisions of laws, Executive Orders or Treaties protecting Indian fishing activity are not to be construed to provide an exemption from Federal income or social security tax which is any broader than the exemption provided by Section 7873.**

INCOME EARNED BY INDIANS MANAGING AND REARING FISH SHOULD BE EXEMPTED FROM INCOME TAX BY THIS BILL

The House Bill exempts Indian income earned while harvesting, processing, or transporting fish harvested under the applicable Treaty. The Report of the House Ways and Means Committee explains that this definition includes income earned through 'aquaculture'. However, tribal members employed in managing the fishery or rearing the fish may still be subject to taxation of their income, notwithstanding the language in the report.

The language of the Bill focuses on the catching and selling portions of the Treaty right, but does not deal with the raising and administration areas secured by the Treaty. There is no logical reason to distinguish between Indians who manage the fishery and raise the fish and all other Indians who earn income from exercise of the Treaty right. While rearing and administration do not involve as many tribal members as the harvesting, processing and transporting functions of fishing, they are just as important.

Inclusion of the words "managing and rearing" within the definition of "treaty fishing-related activity" would clarify Congressional intent that all income from treaty protected activities is exempt from taxation, and would avert potential litigation regarding the scope of the Bill.

In the original 1974 decision in United States v. Washington, 384 F. Supp. 312, at 340 (W.D. Wash., 1974, Judge Boldt confirmed that the Treaties gave the Tribes the right to regulate the treaty fishing of their members. Tribal regulation required each tribe to have management and enforcement capabilities including a tribal government which could promulgate and enforce fishing regulations, manage properly trained enforcement personnel, and use staff or contracted fisheries scientists and managers. The tribal right to manage the fishery has been confirmed by numerous court rulings, and was explicitly recognized by the Congress in the Pacific Salmon Treaty Act of 1985, P.L. 99-5.

The Indian Tribes of the Pacific Northwest produce millions of salmon which are released into the waters of Washington, Oregon and Idaho. These fish are caught by all users, Indian and non-Indian, in salt and fresh water. The United States District Court in Phase II of United States v. Washington, 506 F. Supp. 187 (W.D. Wash., 1980) recognized that there was no difference between hatchery and natural fish so far as the treaty fishing right was concerned. The Court also noted that the purpose of the hatchery fish was to supplement the natural fish populations in places where man has damaged the natural runs. The Phase II decision, like the original ruling, recognized that the Treaty Fishing Right encompassed the right to take advantage of the technological advances in fisheries science. These advances include the rearing of fish.

INDIVIDUAL/CORPORATE PROCESSING EXEMPTION REQUIREMENTS ARE UNREALISTIC AND THE PROJECTED LOSS TO THE TREASURY ARE GROSSLY EXAGGERATED

Two other issues regarding H.R. 2792 deserve mention; namely; (1) the complex requirements imposed on individual Indian or Indian-owned corporations processing fish are prohibitively cumbersome and unrealistic; and (2) the annual tax revenue estimate of $8 million annually we believe is grossly exaggerated based on known tribal fisheries operations.

H.R. 2792 as passed by the House largely restricts the definition of "fishing rights-related activity" to activities carried on within a single tribe. Generally, if part of an activity is performed by members of a tribe other than the tribe whose members caught the fish, then, the activity is taxable. The exception to this rule related to qualified Indian entities engaged in fish processing or transportation where members of multiple tribes own at least 10 percent of the equity interests in the entity. In this instance, there are significant issues of how income is traced and allocated within the entity and among the equity holders. The allocation issues have been left for Treasury to address in regulations.

The Tribes involved in the treaty-right fishing do not believe that this tribal boundary approach is realistic given the nature of their fishing resource and the history of the Tribes. While the Tribes are sensitive to the House concerns that large Indian-owned interests should not dominate substantial portions of the fishing industry, the Tribes believe that the House concerns can be addressed with less restrictive rules.

There are two approaches which establish boundaries that will meet our concerns and which are economically viable within the fishery. The first approach would draw the boundaries at the usual and accustomed fishing area of the processor's tribe. The second approach would group together tribes which signed the same treaty in the 1850's. We would be pleased to provide ample justification to these approaches.

The revenue estimate cost to the Treasury is projected at $8 million annually in H.R. 2792. Our generous estimates for existing Western Washington Tribal fisheries operations, stretch the potential loss to the Treasury to a total of $625,000 annually in 1987 dollars. As the Pacific Northwest Tribes harvest a major portion of treaty fish, we are indeed mystified by the size of the established revenue estimates in H.R. 2792. Again, we would be most willing to provide our calculations for Committee consideration of a more realistic figure.

CONCLUSION

In closing, I can only stress our deep concern that H.R. 2792 becomes law during the 100th Congress. The Treasury Department has forced us to seek Congressional clarification on the tax exempt status of our treaty-protected fishing rights. Now the administration supports H.R. 2792. We would hope the Senate Committee on Finance and the Congress will apply the broadest interpretation of these treaty principles.

I appreciate your time and attention to our views. We are most willing to respond to any inquiries from the Committee on Finance on Indian Fishing Rights clarification.

TESTIMONY OF

REPRESENTATIVE JAMES M. JEFFORDS (R-VERMONT)

ON

THE PENSION PORTABILITY ACT OF 1988

BEFORE THE

UNITED STATES SENATE
COMMITTEE ON FINANCE

JULY 12, 1988 at 9:30 A.M.

PENSION PORTABILITY ACT OF 1988

Mr. Chairman,

First, let me commend you and your Committee for holding today's hearings on the timely subject of pension portability; a subject, I might add, that transcends the obvious and important gains in retirement income security that can accrue to America's workers and their families.

In a broader context, the legislative approach I will present to the Committee for its consideration today also offers great potential for increasing national savings and capital formation and for addressing the issues of worker dislocation, mobility, and competitiveness.

During the enactment of ERISA nearly fourteen years ago, our two Committees and the corresponding two Committees of jurisdiction in the House and Senate were charged to study alternative means of enhancing pension portability and expanding pension coverage. Over the last decade and a half the House Committee on Education and Labor, on which I serve as Ranking Member, has held extensive oversight and legislative hearings on these and other employee benefits subjects with the view towards developing a national retirement income policy.

As I stated over three years ago in introducing bipartisan portability legislation, it is not only my view and that of my Committee, but also the consensus of several Presidential commissions and other private and governmental study groups on retirement that a long term framework should be fashioned in this most critical area of domestic policy. At that time it was clear that several themes stemming from these hearings and studies appeared to have a rather broad consensus among business, labor, and employee/retiree groups. Briefly stated they encompass the topics of pension portability, pension coverage, and what I will term "pension preservation." These three topics remain as choice candidates for inclusion in any revised retirement policy structure which seeks to improve on the efficiency of the current framework serving to supplement Social Security, that is, employer plans and individual retirement savings. That framework is essentially a voluntary one, and I believe that we in Congress must be careful to recognize that element as we fashion our intended improvements.

Over the past few years there has been a strengthening of the consensus for an improved retirement income policy framework, especially as the details of this framework have been refined. To illustrate, I would call to the Committee's attention the degree of unanimity accompanying the recent recommendations of the Advisory Council established under ERISA. In March the business, labor, retiree, and public representatives on this Council recommended a change in law requiring private pension plans that permit lump sum distributions to transfer such amounts to financial intermediaries. In general, the Pension Portability Act of 1988 as reported by the Committee on Education and Labor on April 28th incorporates just such a feature as the presumptive form of distribution for terminated employees who receive distributions prior to retirement.

The ERISA Advisory Council also made a number of other positive recommendations regarding portability and expansion of pension coverage, including a provision to allow employees who are not otherwise covered under a pension plan to request of their employer that a salary-reduction SEP be established for their contributions. As to this last innovative feature, I'd like to recognize that my colleagues in the House, Representatives Bob Matsui, Edward Feighan, and Rod Chandler, had the foresight to include just such a provision in the pension portability legislation they've introduced (H.R. 1992 and H.R. 2643).

At this point I would like to briefly describe the features of the Pension Portability Act of 1988 (H.R. 1961) as they were reported by the Committee on Education and Labor (House Report 100-676, Part 1). The reported bill has also been jointly referred to the House Committee on Ways and Means for legislative consideration. The legislation is identical to S. 2343 which was introduced by Senator Dan Quayle on April 28th. I should point out that this legislation has been developed on a bipartisan basis, is cosponsored and supported by our Committee and Subcommittee Chairmen and Ranking Members, and has been approved unanimously by the full Committee on two separate occasions. As reported on April 28th, H.R. 1961 also reflects several changes to the pension portability provisions as they were passed by the House last year under budget reconciliation. The changes were made to conform the provisions as closely as possible with specifications that had been suggested by the Administration during the budget reconciliation conference.

As revised, this legislation containing the "portable pension plan" concept is intended to directly address the needs of our increasingly mobile labor force and to better preserve current pension plan asset accumulations of over $2 trillion for the payment of retirement benefits.

Today too much of this $2 trillion in assets, which NBC News labeled "The Biggest Lump of Money in the World," is being cashed-out, thus reducing future retirement income security and our pool of national savings and increasing the burdens on Social Security. From another perspective, our increasingly mobile labor force, while generating a more frequent turnover of pension assets, is demanding a more attractive pension portability vehicle than currently exists. The Pension Portability Act meets these dual and seemingly conflicting challenges by permitting portable pension plans (i.e. individual retirement plans and SEP's) to be set up by private sector investment managers in order to receive, on a tax-free basis, those employer plan distributions that would otherwise be cashed-out.

In several specific ways, the proposal encourages a form of voluntary portability from existing tax-qualified pension plans. First, the current law prohibition on the direct transfer of employee contributions from pension plans to IRA's is removed. The Pension Portability Act would permit all or a portion of a terminated employee's benefit under a qualified plan, including the employee's own after-tax contributions, to be transferred tax-free directly from the plan to a portable pension plan.

Secondly, unless pensions are paid in annuity form the direct transfer from qualified plans to a portable pension plan would become the presumptive form of distribution. Not all plans, but at least those qualified plans that allow for single-sum distributions would have to provide employees who are eligible for a distribution under the plan with an option to transfer their benefits. Such sums would be made to a portable pension plan in a direct trustee-to-trustee transfer. A plan would be allowed to provide this portability transfer option as the only option or as one of other distribution forms, including the joint and survivor form as under current law. Also, if the qualified plan provides, employees would be permitted to elect out of the portability transfer option and receive their benefits in another form allowed under the plan. To encourage the employee and the employee's spouse to utilize the tax-free portability transfer, the plan must provide an explanation of the possible adverse tax consequences of not taking such a transfer.

Thirdly, plan sponsors would be allowed to reduce their recordkeeping burdens by transferring the pensions of terminating employees to portable plans. Thus, the portability of pensions in any amount would be encouraged by permitting plans, without obtaining employee or spousal consent, to make such transfers. This procedure would be allowed, and the current $3,500 restriction would be eliminated, because the receiving portable plan would be treated as a transferee plan that protects any spouse and provides a "core" set of distribution options.

Finally, the portability of pension amounts between plans would be improved. Direct trustee-to-trustee transfers would always be allowable among portable plan IRAs, and as under current law, previous "rollovers" or transfers from qualified plans to IRAs, which are separately accounted for, may be transferred back to qualified plans of the same type.

For several reasons I believe it critical that this Congress move expeditiously on these pension portability and asset preservation provisions I've just described. The recent number of terminations of overfunded pension plans has led in many cases to the lump-sum cashout of vested benefits, thus undermining the future retirement income security of employees choosing cash rather than annuities. The adoption of these provisions would help assure that such sums continue to be invested for retirement purposes. Also, the Tax Reform Act's amendments shortening ERISA's vesting provisions from 10 to 5 years will undoubtedly result in a further acceleration in both the voluntary and mandatory lump-sum cashout of vested benefits when short-service employees terminate their employment. Given that plans' vesting provisions must soon be brought into conformance with the Tax Reform Act, it is crucial that the portability legislation be enacted now so that the pension asset preservation provisions can be made effective in a timely manner.

Transcending these short-term concerns and from a more long term perspective, the portable pension plan concept under H.R. 1961 is a key element in furthering spousal pension protection; in furthering the expansion of pension "buy-back" features for teachers, engineers, and other mobile employees; and in encouraging the payment of pension accumulations in annuity-like form to supplement Social Security.

In general, IRAs (including SEP's) would serve as the portability vehicle for benefit transfers from qualified plans. Such benefit transfers could consist of both taxable and non-taxable benefits subject to appropriate reporting requirements. Separate accounting of such amounts, including earnings thereon would make the amounts eligible to be transferred back to qualified employer plans.

In addition, the IRA portability vehicle would be subject to the Retirement Equity Act spousal protection rules as though they were defined contribution plans of the profit-sharing type. By treating the portability vehicle as a transferee plan, the spouse or other beneficiary designation under the qualified plan would continue to be effective with respect to any benefits transferred.

Lastly, the IRA portability vehicle would have to make available a number of core distribution forms -- for example, lump sums, joint and survivor and single life or quasi-annuity forms, and ten year installment forms.

In addition to pension portability and pension asset preservation, my Committee colleagues and I consider the widespread lack of pension coverage to be one of the most serious problems remaining to be addressed by ERISA. About one-half of this Nation's recent retirees must meet their retirement needs without the benefit of employer-sponsored or other individual retirement savings. Even today, far too many of the Nation's workers must rely on Social Security alone for their retirement income security.

H.R. 1961 begins to address this need by reducing the administrative and cost barriers currently hindering employers from establishing plans and making contributions. By establishing portable pension plans under which employers and employees may make contributions as circumstances permit without having a continual and annual obligation to do so, the bill gives recognition to the fact that one of the major reasons that some small employers are reluctant to establish plans is a concern that they will be unable to make the annual required contribution.

Also, by removing the restriction on the size of the employer who can enroll their uncovered workers under a salary-reduction SEP, the legislation intends to simplify the administration and operation of SEP's, thus encouraging the expansion of pension coverage. Under a new simplified formula, employers would be able to make contributions on any combination of a percentage-of-compensation or fixed-dollar-per-participant basis. Employees would then be able to contribute to the plan on a salary-reduction basis in any amount up to the employer's contribution. Employer and employee salary-reduction contributions would be subject to the limitations on contributions under existing law. Besides being an administratively simple and attractive means for employers to establish pensions for their employees, it has been demonstrated that employees are more likely to contribute and save if employers lead the way and the amounts contributed do not show up in an employee's W-2 wages.

H.R. 1961 offers additional encouragement for the establishment of portable pension plans by clarifying and simplifying the application of ERISA to such plans. In this connection the ERISA funding rules would be made inapplicable to SEP's and other IRA pension plans. To eliminate the inconsistency of SEP rules under current law, ERISA would be conformed to the vesting, participation, and distribution rules applicable to SEP's under the Internal Revenue Code.

In summary, Mr. Chairman, as a key element of the national retirement income policy advanced by my Committee on Education and Labor, the Pension Portability Act is designed to improve retirement income security and address issues of worker dislocation, mobility, and competitiveness by enhancing pension investment choice, national savings and capital formation. I would observe that these goals are also consistent with the employee pension plan policies adopted pursuant to the Tax Reform Act of 1986 and its ERISA predecessor.

Because of the long and careful study we've made of the pension portability and pension coverage issues, I believe the Congress can now take these significant steps while at the same time maintaining the delicate balance needed to protect employee interests and preserve the best features of both defined benefit and defined contribution plans under our private pension system.

In conclusion, I look forward in the days ahead to working closely with you, Mr. Chairman, the other members of this Committee, the Administration, and other interested parties so that by means of the early enactment of the Pension Portability Act of 1988, we can begin moving towards the goal of increasing pension coverage, portability, and retirement savings.

STATEMENT OF ESOP ASSOCIATION

J. Michael Keeling, Esq.

Chairman Baucus, members of the Subcommittee, I am J. Michael Keeling, and I am General Counsel to the ESOP Association. I am also Of Counsel to the Washington, D.C. law firm of Zuckert, Scoutt & Rasenberger.

The ESOP Association is a non-profit organization with over 1200 members nationwide, the majority of whom are ESOP companies. The Association's offices are located at 1100 17th Street. N.W., Suite 310, Washington, D.C.

Mr. Chairman, it is a pleasure and honor to speak to your committee. You are considered to be a great friend of employee ownership by the ESOP community.

The ESOP Association opposes S. 2078. S. 2078 would require pre-transaction approval by a majority of a company's employees before an ESOP could be established.

The reasons for the Association's opposition are many.

One, ESOPs are governed by ERISA, which means that they are part of the private voluntary retirement system that is funded through the voluntary contributions of employers. The decision to establish a qualified compensation plan is a voluntary one made by the employer.

S. 2078 would make the ESOPs uniquely different from other plans which may be invested in employer stock, such as profit sharing plans, stock bonus plans, savings or thrift plans, and the popular 401(k) plans, by requiring an employee vote to approve establishment of an ESOP.

As we walk through the ramifications of an employee vote before establishment of the ESOP, it will become clear why an employer would more often than not elect to create a profit sharing, stock bonus plan, or other similar arrangement, on a voluntary basis instead of an ESOP.

Our second reason for opposing S. 2078 is because it erodes the role of the ESOP trustee, a fiduciary.

ERISA is a set of procedural safeguards. The responsibility of protecting participants in an ERISA plan is on the plan fiduciary who is required to act for the exclusive benefit of the plan participants.

In addition, the ESOP fiduciary has perhaps even more difficult burdens than other ERISA fiduciaries. For example, the law requires DOL and IRS to give special scrutiny to a leveraged ESOP transaction. Recent DOL enforcement actions have actually undone proposed ESOP transactions.

We maintain that there is very little evidence that ESOP fiduciaries do not act exclusively in the interests of plan participants. Where there is a doubt, the Department of Labor has brought legal action against the fiduciary and the plan sponsor. We welcome vigorous enforcement of the law by the Department.

Although not clear in the introductory statement by Senator Armstrong accompanying S. 2078, it is to be assumed that the proposed employee vote may result in the absolution of the fiduciary of responsibility for negotiating the terms of an ESOP transaction, the reviewing of the value of the consideration given by the ESOP for employer stock, or safeguarding the welfare of the participants.

Removing the qualified fiduciary, who is often an independent trustee with independent financial and legal advisors, from the process of establishing an ESOP, will not benefit employees.

In searching for the legal framework that would accompany the implementation of S. 2078, the only analogy lies in our labor laws, and the regulation of employee votes by the National Labor Relations Board (NLRB). Here lies our third objection. S. 2078 creates unanswered questions for labor-management relations.

Under current Federal law, Congress requires an employee vote only when there is evidence that a certain number of employees wish to vote for a labor union to bargain for them with management.

These employee votes are governed by Section 29 U.S.C. § 159 of the National Labor Relations Act. This Act, and related laws, are popularly called the Wagner Act, the Taft-Hartley Act, and the Landrum-Griffin Act. 29 CFR §§ 101/102, issued by the NLRB, provides greater detail about how these employee votes are to be called, conducted, and certified. These laws and regulations are long, and complex.

Conflicts arising from these employee votes are too numerous to count. One short treatise on NLRB elections listed, in 1979, over 525 major court decisions on these election disputes.[1] There are literally thousands and thousands of unfair labor practices filed with the NLRB arising from elections since enactment of the Wagner Act in 1935.

What are these lawsuits about? The issues are obvious: What is the duration of the election? What is permissible behavior during the election period, by management, by employees (is face to face campaigning permitted, is campaigning permitted during work hours, at residences, over the airwaves, etc.)? Who is eligible to vote? Who counts the vote? Who certifies the election? Who decides if an unfair practice influenced the vote outcome? Who stops the election process if a significant unfair practice occurs during the campaigning/election process?

It is reasonable to expect that a vote requirement in the ESOP context would create the same mass of confusion.

And this brings us to the fourth reason for opposing S. 2078.

The ESOP Association has as members most of the successful ESOP companies in America.

The overwhelming majority look at management-employee teamwork as a key element in their success.

The teamwork that accompanies the ESOP is not born in an adversarial relationship.

S. 2078 would automatically convert the normal ESOP creation process into one of suspicion and hostility because it would require a wall being dropped between management and employees.

For example, if you personally visit an ESOP company, you will probably find direct evidence of the bond of ownership between management and employees .

Typically, the ESOP in a closely-held company is the result of thinking by one or two owner-managers. It is common in such circumstances for the current owners to go to the 100 to 1000 employees, who they may know on a first-name basis, and announce what is perceived as a great employe benefit -- employee ownership. The employees make no wage concessions, give up no other employee benefits, and react in an upbeat manner.

Under S. 2078, the first message to the employees by owners-managers would be -- "We would like to create a progra of employee ownership -- an ESOP. But Congress has decided ESOPs are dangerous, unlike profit sharing plans, 401(k) plans, and stock bonus plans. So we have brought some people you do not know to tell you the plus's and minus's of ESOPs because we cannot try to persuade you to vote for the ESOP."

The reaction of any normal employee would be -- "WOW, ESOPs are bad. These managers are up to something. This looks like an 'us' versus 'them' issue."

So S. 2078 would automatically create a negative patina around ESOP creation where currently, in the typical ESOP company, the ESOP is created in an amicable environment between owner-managers and employees.

Furthermore, if the employee vote is close, the possibility that the ESOP will be a positive force in increased corporate performance is unlikely.

The above-related scenario of the changes fostered by enactment of S. 2078 leads to the fifth reason the ESOP Association opposes this legislation.

It is still a fact that most ESOP companies -- companies with a significant level of employee ownership -- are small to mid-size corporations with 100 to 1000 employees. These companies are closely-held and have never had their stock publicly traded.

If this class of company is faced with an employee vote before creating an ESOP, the vote may require registration with the Securities Exchange Commission, because the action would be similar to many individual investors making a stock investment decision.

The expense of SEC registration, filing stock prospectus, and annual reports are well-documented, and it is an expense avoided by most U.S. business owners.

Reasons 1 through 5 all lead to an overwhelming conclusion. When the business man or woman of the typical U.S. corporation is presented

- with the detailed dictates of an employee vote;
- with registering as a publicly-traded company;
- with bringing in strangers to be a buffer between them and their employees; and
- with the plan fiduciary absolved of his or her duties to act in the exclusive interest of participants,

as contrasted with setting up a profit-sharing, stock bonus plan, 401(k) plan, with having none of the above-cited headaches, that corporation will not create an ESOP.

Mr. Chairman, S. 2078 goes to the essence of debate about ESOPs -- are they good for employees, for America, or are they bad for employees.

The debate swirls. We believe that the evidence is overwhelming that the vast majority of ESOPs do work for employees.

It particularly works for employees and America in that sector of the economy very important to our nation's future -- small and mid-size privately-held corporations.

To illustrate our point, I ask your consent to include in the hearing record a recent article in INC magazine by John Casey -- "ESOPS -- Dead or Alive?" (Attachment 1.) This is not an

ESOP puff piece. The author had read all the "exposes" of ESOPs by the "big" name financial and popular press, and set out to blast ESOPs. Instead he did what you have done Mr. Chairman. He actually met with ESOP company managers and employees. He found most very happy, and well off financially.

So the article presents the problems of ESOPs for small and mid-size companies, as well as the plus's.

Turning to the large, publicly traded corporations, since 1986, these companies in greater numbers are looking at ESOPs. Some, very few, have actually begun a significant employee ownership program. The results are encouraging, and we believe that the success stories will move larger companies to ESOPs. Because timing is key to obtaining financing by large company ESOPs, and because large, publicly traded corporations frequently have union-represented bargaining units negotiating for employees, S. 2078 would slow significantly large company ESOP creation, and would erode labor union power to represent its members. This is our sixth reason for opposing S. 2078.

S. 2078 would also discriminate in favor of the hostile, third-party raider, whose actions may result in some employees losing their jobs, over a group of employees who may want to acquire the corporation to save their jobs.

Mr. Chairman, ESOPs are not all perfect. Much controversy arises when an ESOP gets thrown into the volatile mix of a takeover fight, labor-management strife, or both.

The ESOP Association has worked closely with its friends in Congress, and the Department of Labor to ensure the employee is protected in these situations, and that the fiduciary meets his responsibilities to act in the exclusive benefit of ESOP participants.

For example, our friends proposed the 1986 reforms on diversification, independent valuations, and mandatory payout. Our friends proposed the tightening of voting rights in 1986. We welcomed Assistant Secretary of Labor, David Walker, when he came to us to speak to our Conventions.

For example, under Assistant Secretary Walker's prodding, the Secretary of Labor's ERISA Advisory Committee spent over one year studying thousands of pages of testimony and documents from ESOP critics and supporters. The Advisory Committee reviewed the very issues mentioned by Senator Armstrong when he introduced S 2078. After the one year study period, the Advisory Committee submitted recommendations to the Secretary of Labor on ESOPs in large, complex transactions. Although the ESOP Association does not agree with all of the Advisory Committee's recommendations, we do commend the serious study given to ESOP issues, and we were honored that Assistant Secretary Walker sought our views during the year long study.

The Association pledge to continue to work with Congressional ESOP supporters to encourage more employee ownership and to make ESOPs better.

In summary, Congress has enacted laws for over 15 years encouraging the creation of ESOPs and employee ownership so that capital ownership can become more widespread. The sad fact is that the number of ESOP companies in America is still rather small compared to the total number of companies. One suspects that the many regulatory and costs hurdles to establishing an ESOP, along with the psychological barrier of sharing ownership, limits the number. We do not need new hurdles such as S. 2078 would create.

I will be pleased to answer any questions.

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[1] R. Lewis and W. Krupman, Winning NLRB Elections (1979).

ATTACHMENT 1

ESOPs

DEAD OR ALIVE?

Sure, ESOPs can be cumbersome and tricky. But despite the bad press, they can be exactly what your company needs

BY JOHN CASE

STORY PROPOSAL

I've been reading negative stories on employee stock ownership plans for years. That scarcely prepared me for what I found at last year's National Center for Employee Ownership conference. It was attended by hundreds of small-business people, and most were *pleased* with their ESOPs. Later I began visiting ESOP companies and learning about their experiences. My conclusion: smaller companies have been figuring out how to use ESOPs to their advantage. Let's sort through what they've done and tell our readers what works—and what to watch for. —J.C.

EMPLOYEE STOCK OWNERSHIP PLANS—ESOPS—have been around for a while now, and plenty of companies have tried them. Having spent a year or so studying up on the experience, I've come to a couple of conclusions.

One: It would be *very* easy to argue that no company owner should even consider installing an ESOP.

Just think of all the companies with employee ownership that got themselves into trouble. Frank Borman, chief executive officer of Eastern Air Lines Inc., agrees to give workers about 20% of the stock in return for wage concessions. And what happens? Losses mount, unions and management keep on bickering. Employee owners vote to sell *U.S. News & World Report* to would-be media mogul Mortimer B. Zuckerman. Immediately the deal gets tied up in lawsuits—*ex*-employees feel they've gotten the shaft.

The cautionary tales aren't limited to large companies. "If I had it to do all over again, I wouldn't have an ESOP," says Phil Grogan, who led an ESOP-financed buyout of Keyser Garment Inc., a small clothing manufacturer. Elliot Schrier, president of a San Francisco consulting firm called Manalytics Inc., set up an ESOP but terminated it this year. At least Grogan and Schrier talked to INC.; another CEO wouldn't let us get past his secretary. "He doesn't wish to discuss the ESOP," she informed us icily. Too bad; we'd heard he'd had some *serious* problems.

All this was beginning to add up to yet another negative article on ESOPs. But wait! There seemed to be a few other experiences—no, a *lot* of other experiences—that didn't fit this sour view.

For one thing, the number of ESOPs is continuing to grow. "About 700 to 800 new ESOPs are established every year," says Corey Rosen, executive director of the National Center for Employee Ownership, a research organization. Most of them, Rosen adds, are in small, private companies. All told, there are maybe 9,000 U.S. companies with ESOPs.

Then too, there are just too many CEOs who *like* their ESOPs. Henri Bertuch, for example. Until recently Bertuch was sole owner of D.V.C. Industries Inc., a Bay Shore, N.Y., manufacturer of looseleaf binders and packaging materials. Then he established an ESOP and sold it 30% of his stock. Now, he says, he's "in a dreamworld." Not only does he have a hefty jingle in his jeans, but his company has a new team spirit. For years, D.V.C.'s sales had been flat, hovering around $15 million. In 1987, the first full year after the ESOP was installed, revenues were up 8%, pretax profits up 64%. This year looks even better, with sales running ahead of last year's by 28%.

As it happens, Bertuch isn't the exception, he's the rule. Over the past 12 months I met with dozens of executives who had installed ESOPs. I attended conferences at which dozens more lauded the plans. I talked with employees and experts—and came to another conclusion.

Yes, ESOPs can cause problems. And yes, the problems can sometimes overwhelm the benefits. But the difference between ESOPs that work and those that don't isn't blind luck. Rather, it's knowing when an ESOP is appropriate and when it's not—and how to use it when it is. An ESOP can accomplish everything it was designed to accomplish. For some companies it can work wonders.

With that in mind, here's INC.'s question-and-answer guide to ESOPs—the promises and possibilities, the problems and pitfalls. There are plenty of each.

HOW AN ESOP WORKS

The mechanics of employee ownership

A nonleveraged ESOP—still the most common variety—is simply a trust set up to hold company stock for the benefit of employees. ABC Inc. creates the trust and annually contributes stock, treasury stock, or cash, up to 25% of covered payroll. If the contributions are in cash, the ESOP uses the money to buy stock from existing shareholders. Stock is then credited to individual employees' accounts, usually vesting over a period of up to seven years. Unless ABC is a publicly traded company, it must offer to buy the stock back when the employee leaves or retires (the payout can take place over several years). ABC's contributions of stock or cash are tax-deductible; so are cash dividends passed through the ESOP to employee shareholders.

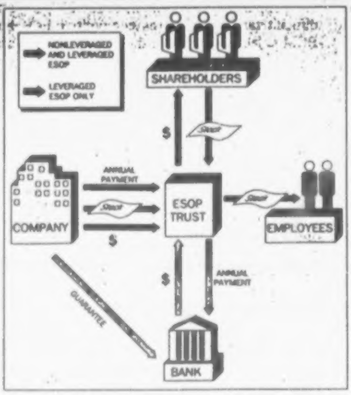


CHART: NEIL PINCHIN

A leveraged ESOP works in the same way, except the ESOP borrows the money to fund its purchase of company stock. ABC provides or guarantees the loan to the ESOP and contributes cash or pays dividends sufficient to enable the ESOP to repay it. As the loan is paid off, the stock it bought is credited to employee accounts. ABC can deduct the full value of loan repayments (principal and interest) from its taxable income, though contributions used by the ESOP to pay the principal can't exceed 25% of covered payroll. Since the bank gets a tax break on its earnings from the loan, rates are typically 75% to 90% of the company's usual rate. If the borrowed funds are used to buy new stock (rather than to buy out existing shareholders), the company gets full use of the proceeds.

OK, given all the sad stories about ESOPs, why should I even consider installing one at my company?

In a word, liquidity.

Owners of small, private companies usually engineer an ESOP to create a market for their stock. It's a way of cashing in—or out—without going public or selling the company. The tax breaks are huge. The psychic rewards—well, let Bertuch tell it.

In December 1985, at age 54, Bertuch was beginning to think about getting some of his money out of the business his family had owned for three generations. An IPO was out of the question. D.V.C. Industries was in too unglamorous an industry, its sales and earnings too lackluster. Granted, some would-be buyers were sniffing around. But Bertuch couldn't see selling. An acquirer would probably move the business, costing a generation of loyal employees their jobs. Family members who might want to come into the company—Bertuch was thinking mainly of his sons Michael and Mark—wouldn't get the chance.

And oh, those tax breaks. Bertuch sold his new ESOP 30% of his stock. That made him eligible for so-called rollover treatment: all he had to do was reinvest the proceeds in other U.S. corporate securities, and the tax on his gains was completely deferred. If he dies before selling the new assets, his heirs can avoid income tax on the gains *entirely*. To buy Bertuch's stock, the ESOP borrowed $1.8 million. Because banks get a tax break on ESOP loans, the interest rate was 82% of prime, not the point or so over prime that D.V.C. normally pays. And because both principal and interest payments are tax-deductible, D.V.C.'s ESOP is buying the stock with pretax dollars as it pays down the seven-year loan. Had it simply retired Bertuch's stock, the company would have been using aftertax dollars. And it wouldn't have gotten a break on the loan rate.

The story of Henri Bertuch is the reason why the number of ESOPs continues to grow: a lot of people are, or will be, in his situation. Are you among them?

If you're looking for liquidity; if you want to continue running the company or at least see it remain independent; and if you want to avoid the whopping taxes you'd owe on a cash sale—well, then, some day, you'll at least consider an ESOP. If your accountants don't insist on it, your children will.

The cash and the tax benefits sound great—for me. But what happens to the business?

Rest easy: despite the occasional horror story, thousands of thriving small and midsize companies now have ESOPs. The plans themselves are both a powerful financial tool and a potentially generous benefit.

Consider BCM Engineers Inc., in Plymouth Meeting, Pa. Eleven years ago, BCM employees bought their $6.5-million company from Betz Laboratories Inc. Officers put up about $1.4 million for convertible debentures; the rest, $3.8 million, was paid by a newly organized employee stock ownership plan, which borrowed the money. Today, BCM racks up about $50 million a year in revenues from consulting engineering, mostly in water, asbestos, and waste treatment. A share of stock worth $2.40 in 1977 hit $21.25 at the end of 1987—and last year alone paid its owner a cash dividend of 12.5¢. The ESOP owns more than 85% of the shares.

How much the ESOP contributed to BCM's stellar performance is a question company president James Jablonski doesn't answer directly; engineer-like, he prefers facts to theories. But the facts he cites are compelling. In 1984 the company paid off the last of the purchase loan. Two years later it borrowed $1.5 million for an acquisition, and last year it financed a $1.1-million renovation of its laboratory and equipment. Since both loans were channeled through the ESOP, the bank offered fixed rates of about 80% of prime—and BCM can repay the money with pretax dollars. Put the two factors together, says Jablonski, and you have borrowing costs that are roughly *half* what they would be without the ESOP.

Cheap money; attractive benefit. BCM—which also has a 401(k) retirement plan—

typically contributes 4% to 6% of compensation per year to employee ESOP accounts. With share appreciation, an engineer who started in 1977 and earns $40,000 annually would already have an ESOP account worth roughly $60,000. Employees also get annual dividend checks on their shares, vested or not; and they can vote in shareholder elections after as little as six months of service.

Two years ago the company employed 400 people. Since then it has added 300, a difficult task in a field as competitive as BCM's. Jablonski credits the ESOP. First-rate candidates, he avers, are so much more likely to take a job with stock ownership that the company puts "employee owned", in every advertisement. "It's particularly attractive to engineers coming from closely held firms, in which the prospect of owning stock was so remote," he says.

Brass tacks, please: does stock ownership breed cooperation? Does it make employees more productive?

When ESOPs were new, many observers thought they would solve labor-management problems. Events, alas, quickly overtook hope. In New Jersey, for instance, workers bought out a General Motors roller-bearing plant and set up a new company, Hyatt Clark Industries. But employee ownership never came close to overcoming a legacy of labor-management mistrust, and the company had to file for Chapter 11. Much the same legacy of mistrust undermined Eastern's short-lived experiment in employee ownership. In 1986 CEO Borman demands another 20% wage cut. The machinists union refuses. Borman sells Eastern to union-hater Frank Lorenzo's Texas Air Corp. End of experiment.

In a privately held ESOP company, employees' ownership rights are limited. The stock, typically, is held in a trust controlled by management. Employees don't vote their shares except—as the law requires—on such life-and-death matters as sale of the business. (Even then, their vote doesn't mean much unless they control a majority.) Nor do Securities and Exchange Commission rules about disclosure apply. ESOP shareholders don't have to be kept informed about the plans, prospects, and financial situation of their company.

Such provisions are reassuring to entrepreneurs who fear losing control. But they don't exactly make workers feel like owners. "The employees couldn't care less about the stock," says David L. Stone, a partner with Touche Ross & Co., describing a contentious company that sold its workers a third of the shares. "They know that 65% of the stock still belongs to guys who treat them like garbage and will continue to treat them like garbage."

The fact is, however, that the hopes for ESOPs weren't entirely misguided. The plans *can* foster a spirit of cooperation and can have a positive impact on performance. They just don't do it automatically. That's a conclusion bolstered by interviews with CEOs who not only established ESOPs but have gone out of their way to *treat* employees like owners. Three methods stand out:

☐ Information and communication. "If you're not willing to have a committee," says Bertuch, "you shouldn't have an ESOP." His committee, composed of two people from each department, is the way he disseminates information about the business, including financial figures. The first year after the ESOP was installed, the valuation of the company dropped a little, and Bertuch knew the committee would hold him accountable. It did. "They called me in and asked me about our strategy and long-range plans," he says. "I talked about what equipment we were buying, how we were addressing the problem." Last year the valuation of D.V.C. Industries rose 18%.

Employees have to be able to understand the information they're given. Another ESOP company, Reflexite Corp., distributes an unusual kind of financial statement to employees: every entry is annotated to explain exactly what it means. Bertuch provides the committee with only the ordinary financial statements. But he has invited the New York State Center for Employee Ownership and Participation into his company to teach employees about business. "The more knowledge people have about how a company works—how prices are determined, how we make money—the better off they're going to feel about the company," says Bertuch.

☐ Money. Bertuch doesn't pay cash dividends; instead he contributes 15% of salary to ESOP accounts plus 4% interest per year in addition to stock appreciation. Other ESOP companies, such as Reflexite and

THE BIRTH OF ESOPS

A brief history of employee ownership

ESOPs are testimony to the power of ideas—the ideas, in this case, of an iconoclastic economist named Louis O. Kelso. Coming of age in Depression-era Colorado, Kelso pondered the causes of the economic collapse around him. His conclusion: too few people owned capital. In a modern economy, Kelso figured, that's where real wealth originates.

Kelso kept his ideas to himself until 1958, when he published (with the philosopher Mortimer J. Adler) a book modestly titled *The Capitalist Manifesto*. It sold a lot of copies but left little impression on economists or policymakers. Never mind: a later book, *Two-Factor Theory: The Economics of Reality*, found its way to one E. Wayne Thevenot, executive assistant to Senator Russell Long, the powerful chairman of the Senate Finance Committee. Thevenot introduced the two men—and Long, son of fabled populist Huey Long, liked what he heard. "If my pappy had had this idea," Kelso remembers Long telling him, "he *would* have made every man a king."

For the next 13 years Long wheedled and cajoled Congress into approving ESOP-related amendments to the tax code. Now, however, Senator Long is retired, and federal revenue needs are putting pressure on tax breaks of all sorts. Does that presage an end to the ESOP goodies? Probably not, say the experts. A few legislators, such as Representative Fortney H. "Pete" Stark (D-Calif.), like to attack ESOPs, but the vast majority is either sympathetic or neutral.

Kelso, now in his seventies, is gratified by the proliferation of his intellectual offspring, but bitter that economists still pay him so little mind. "I had the bad luck," he complains, "to displease the most arrogant profession on earth."

ESOP originator Louis O. Kelso
He proposed the idea in 1958.

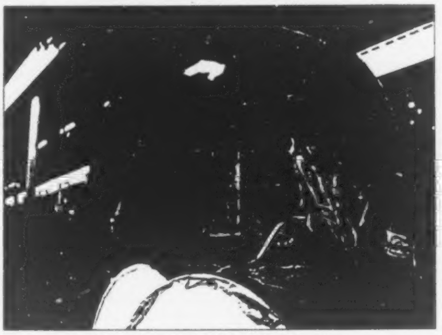
PHOTOGRAPH: JOHN HARDING

CASE STUDY

How one family business did it right

Clay Polk, 28, is a supervisor on the second mail-room shift at Solar Press Inc., and today he is complaining to management. The tools needed to fix a jammed machine, he says, are always getting lost. Work stops while the crew chiefs look for them.

This, it is plain, is not your ordinary workplace complaint. Polk is the leader of a group of four other hourly workers, and together they have researched their grievance to within an inch of its life. They know how often the machines jam up, how long it takes to find the tools, and how much the unnecessary downtime costs the company. And they have a proposal: buy the 17 mail-room crew chiefs individual sets of tools. Hand-lettered wall charts compare the cost of the new tools with the costs of the current situation. If management will pay for the tools, Polk says, his group will come in before work to build toolboxes and a depot to keep them in. And oh, yes: crew chiefs will replace any tools they lose.



Supervisor Clay Polk of Solar Press Inc.
Employees are entrusted with information and responsibility.

Management—represented here by vice-president of finance and administration Joe Hudetz and mailing-department manager Chuck Ortinau—is convinced. When the plan proposed by Polk's group goes into effect, the annual savings could come to $8,000.

Not much for a $27-million business? Maybe—but then this group is only one of 16 "creativity circles" established throughout Solar Press since January 1987, and all of the 16 groups are busy coming up with ideas to save money or improve quality. The customer-service reps realized that job tickets were being written up in a dozen different ways, leading to recurrent production foul-ups, and are writing a manual to standardize procedures. A pressroom circle figured out how to save thousands of dollars in wasted paper by opening the rolls differently.

All this, oddly enough, is part of Joe Hudetz's plan—a plan that began with wondering how he and his 10 brothers and sisters, owners of the company their father had started, could solve two problems.

The siblings' immediate concern was liquidity. Solar was highly profitable, but shares in the privately held company had no market.

For those active in the business—

BCM Engineers, boost the ownership message with regular cash dividends. "We pay them in the summertime, right around the Fourth of July," says BCM's Jablonski. "It really makes the ESOP mean something more than just a stock certificate."

☐ Participation in management. At BCM—and at other ESOP companies that pass voting rights through to employees—workers elect the board of directors, just as shareholders do in a public company. But participation need not be limited to elections, nor to the kind of consultation Bertuch has established with his committee. At Clay Equipment Corp., an Iowa manufacturer of farm equipment that installed an ESOP a few years ago, employees meet in groups to discuss ways of increasing sales, cutting costs, and improving products. At Phillips Paper Corp., a San Antonio distributor of packaging to the fast-food industry, employee committees make nearly all decisions relating to working conditions, benefits, equipment purchases, and sales policies.

The CEOs who treat employees as owners swear by their methods—which is not to say that those methods are appropriate for all. But at least some evidence points to an effect on company performance. A National Center for Employee Ownership study, for example, found that a sample of 45 companies grew faster after establishing an ESOP than they had been growing before, with sales rising fastest in high-participation companies. And a recent report by the U.S. General Accounting Office found a positive relationship between employee participation and corporate productivity, though no relationship between economic performance and ESOPs in general.

Information sharing, generous compensation schemes, participation in management—is it all a bit much? It was for Phil Grogran of Keyser Garment, who resented the fact that, as he put it, "There are certain individuals who think they own the plant and think they should run it." If you're in Grogan's camp—if you'd just as soon not rock the managerial boat—you may not want an ESOP.

But if you believe that a culture of cooperation is exactly what your business needs, you may well want to start with sharing ownership—and then learn to involve your employees in the operation of the company. The one without the other may give you some tax breaks, but it won't have any positive effect on the way your business works.

So far, so good—but aren't ESOPs expensive and complicated? And can't they backfire?

Yes, and yes.

First come the consultants, then the lawyers and accountants. A feasibility study alone can cost several thousand dollars. If you decide to proceed with the plan, you'll spend at least $15,000 to set it up. Once it is in operation, moreover, the law requires a complete annual valuation of the company, and someone on your staff will have to spend large amounts of time administering the plan. ESOPs are even more complex than other tax-qualified retirement plans—themselves no models of simplicity—because the relevant rules and regulations are still being written.

These administrative costs alone can blunt the attraction of an ESOP. "For small companies, the costs are really just too high," says Elliot Schrier of Manalytics, the San Francisco consulting firm. An ESOP isn't cost effective, experts agree, until the payroll is larger than 15 or 20. Similarly, if all you want is an employee benefit—and you don't particularly care about the tax and

PHOTOGRAPH: DAVID SUTTON

there are six Hudetz brothers running the company—the problem was managing Solar's explosive growth. As recently as 1980, the Naperville, Ill., company had about 30 employees and $2 million in sales. As business soared—and as the number of full-time workers passed 200—Solar began losing its family-run culture. In the past, the Hudetzes had known all the employees, and had worked out of offices right on the shop floor. Now there were too many people, and communication between managers and workers was breaking down.

Joe Hudetz isn't the chief executive; that job belongs to younger brother Frank, who has been with the company longer. But it was Joe, a lawyer and CPA, who introduced ESOPs to the rest. By 1986 Solar had established its plan.

The advantages were apparent immediately. The ESOP borrowed $4 million and passed the loan through to the company, which retired an equivalent amount of long-term debt. Since principal and interest on ESOP loans are tax-deductible, Solar saved some $150,000 a year. It contributed that money to the ESOP, which began buying family members' shares and allocating them to employees' accounts. Solar found it could contribute 15% of payroll to the ESOP—roughly triple what it had contributed to its old profit-sharing plan, and at no extra cost. At this rate, employees will own 25% of the business by 1996.

But Joe Hudetz had management on his mind as much as finance. "We wanted to reverse the trend toward top-down management," he says, "and get back to a group effort, the way it used to be." An ESOP alone, said the experts Hudetz consulted, wouldn't accomplish that goal. Employees had to be treated like owners, entrusted with information and responsibility; and they had to see some tangible results of their efforts now, not just at retirement.

Hudetz attacked on several fronts. He released the company's first-ever public financial report. He instituted a new gain-sharing system: 25% of all profits over a certain modest target would be distributed as "employee owner bonuses," typically adding several hundred dollars per quarter to veteran employees' paychecks. Most significantly, he established the creativity circles, thereby giving employees a chance to take control of their work lives.

To hear some employees tell it, all this was laid on a little thick. "I was skeptical," says Vince Adelman, a supervisor in the prepress department. "The idea was heavily sold and packaged; the leaders tried to elicit enthusiasm for it. I felt as if I were being manipulated." But, says Adelman, he became a reluctant convert. "What really convinced me was seeing that the system worked. For example, we had a problem with printing-plate rework. We gathered up data, charted it, and ended up reducing rework significantly."

From Hudetz's perspective, the ESOP and its accompanying changes have worked well as management tools: absenteeism and turnover are down, sales and profits up. "The company that we'll own 75% of will grow faster than the company we used to own 100% of," he predicts. But what impresses him most is the way employees now seem to be acting like owners, thinking about their jobs as well as performing them. "The American worker needs a shot in the arm to start being more competitive," he says, "and this gives it to them. They wake up in the morning saying, Hey, I'm somebody—I *own* a piece of this place."

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financial advantages—an ESOP may be overkill. "I could design a stock-option or some other kind of stock plan that would have all the motivational benefits of an ESOP and cost the company less," says Touche Ross's David Stone.

Administrative costs are at least predictable. But there's also a hidden—and unpredictable—cost to an ESOP. Consider: in an ESOP transaction like Bertuch's, the cash borrowed from the bank goes to buy out the owner. Employees get stock, not money. Yet the company or the ESOP must offer to buy back every departing employee's stock at current appraised value. So D.V.C. Industries will eventually be liable for cash outlays beyond what it pays the bank.

This repurchase liability, as it's known, operates by a kind of perverse logic. The faster D.V.C. grows, the more the stock will be worth and the more costly the buyouts. If the company runs into trouble the stock will be cheaper—but there may not be enough money to redeem it. Exactly when the bill will come due, moreover, isn't clear. In a small company, employee departures can't be predicted with precision.

The problem arises whether or not the plan is buying the original owner's shares. A company can contribute new shares to an ESOP, for example, and deduct their full value from its taxable earnings. That's a cash-*generating* benefit plan—but the company will need all these tax savings and a good bit more when employees leave. The situation is the same when a company borrows through its ESOP, as BCM Engineers has done. For every loan dollar that's repaid, the company must credit employee accounts with a dollar's worth of stock. That dilutes existing shareholdings and creates new repurchase liabilities. So the transaction makes financial sense only if the loan "buys" enough growth and profitability to cover its eventual costs.

It's possible to make more of the repurchase liability than it merits. The ESOP is, after all, a benefit plan, and benefit plans do cost money. Even so, some of the companies we talked with had gotten themselves into trouble on this score. A Honolulu entrepreneur, whose company has hit hard times, said he'd have to sell assets to buy out his key employees if they chose to leave. The bottom line? "You have this big uncertainty hanging out there," says Corey Rosen, of the National Center for Employee Ownership. "You're trading a present cash-flow benefit for a future liability of uncertain size."

How else can these plans get me in trouble? Seems to me a lot of ESOPs have wound up in court.

The administrative complexities of ESOPs—and the strict rules governing repurchase—reflect a fundamental tension in the conception of the plans. ESOPs provide all kinds of tax advantages. But they are benefit plans, not just tax shelters, and they're governed by many of the same restrictive laws that govern other tax-qualified deferred-compensation plans. In legal terms, they're expressly required to operate for the "exclusive benefit" of the participants.

That opens the door to plenty of disputes—over valuation, for example. Companies have always been required to assess ESOP stock at fair market value. But the objectivity (or competence) of the appraisers has sometimes been in question. The *U.S. News* case dramatized the potential for, let's say, different interpretations. In 1983, the magazine was appraised at $425 a share; when it was sold the following year, the price was $3,000 a share. Hard times can also cause disputes. When a company goes

RESOURCES

Where to find information on employee ownership

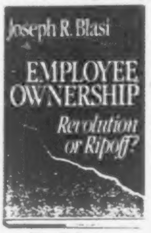
Issue and debates. ESOPs have been what journalists call "good copy" over the past few years. One genre: the gosh-ain't-it-wonderful story, exemplified by any number of Sunday-business-section and regional-magazine articles. But the national press has been more critical. Some notes on the critics:

Forbes just doesn't like ESOPs. "The Myths of Employee Ownership" (April 23, 1984) and "Class Consciousness Raising" (November 30, 1987) argue that worker-owners will milk their companies dry. Why more than corporate owners? The magazine doesn't say. Anyway, in private-company ESOPs employees don't usually make investment decisions.

Business Week's cover story "Revolution or Ripoff?" (April 15, 1985) attacks ESOPs on another ground: they screw the workers. Prime example: at Dan River Inc., where managers set up an ESOP-financed leveraged buyout, workers feel that they "got took." Yet W.L. Gore & Associates Inc. is heralded as an example of a truly successful ESOP. "It's hard to find someone at Gore who doesn't like the job."

Other recent attacks: "The Foibles of ESOPs" (*Newsweek*, October 19, 1987) rehashes *BW*'s fear of fancy ESOP financial deals. "Are ESOPs Headed for Trouble?" (*Institutional Investor*, August 1987) wonders if the tax breaks are too generous. No one—surprise!—says ESOPs don't work for privately held companies. In fact, the opposite: "How Well Is Employee Ownership Working?" a *Harvard Business Review* special report (September/October 1987) by two ESOP partisans, reports flat out that "companies do better after setting up ESOPs."

Recommendation: for solid background information, skip the articles entirely and browse through a copy of Joseph R. Blasi's *Employee Ownership: Revolution or Ripoff?* (Ballinger, 1988), not to be confused with the *BW* piece. It includes all you'll ever want to know about where ESOPs came from, how they work in practice, what legal and practical issues they raise. And—thank heaven—it's eminently fair-minded. Blasi isn't afraid to criticize ESOPs that don't work or to praise those that do.



Blasi's book
All you'll need.

If you're considering an ESOP and want nuts-and-bolts information, here's what to do:

First, contact the ESOP Association, 1100 17th Street N.W., Suite 310, Washington, DC 20036. Ask for its introductory booklet *How the ESOP Really Works* ($10). But also get a copy of the most recent "ESOP Survey" ($5), which will tell you who else has ESOPs and what problems they've encountered; and a copy of *ESOP Directory* ($25), which lists both ESOP companies and specialists in the field.

Second, get in touch with the National Center for Employee Ownership, 426 17th Street, Suite 650, Oakland, CA 94612. Get the introductory pamphlet "Selling Stock to an ESOP in a Closely Held Firm," but also ask for a copy of *Managing an Employee Ownership Company* ($25). It's the best examination of how the way you run your business can be affected by an ESOP.

Both organizations can put you in touch with knowledgeable bankers, lawyers, and consultants who are likely to have informational materials of their own on such matters as valuation and repurchase liability. And both sponsor regular conferences and information sessions around the country.

belly-up, as employees of several defunct airlines and trucking companies have discovered, ESOP assets can vanish into thin air.

Since 1986, the government has required annual valuations by qualified independent appraisers. It also requires that companies with ESOPs offer diversification options (in certain circumstances) to employees 55 and over. The one area it hasn't yet addressed is repurchase liability. The law says you must buy the stock back, but it leaves the planning up to you. And there's no easy way around it. A company can eliminate the liability by going public—but it may have established the ESOP precisely to keep the business private. Short of an IPO, it can either begin putting aside cash or it can take its chances.

With all these complexities, what's the chance that a company with an ESOP will wind up in court? Many troubles originate in the motivation for establishing the plan. If you're interested primarily in the financial advantages—and if the benefits to employees are distinctly secondary—realize you're playing with fire. The law gives disgruntled employees plenty of grounds on which to sue, and it's getting stricter every year. If employees think you're playing fast and loose with them, sue they will.

So what should I do? How should I think about all of this?

The world of ESOPs is filled with irony. An idea born of spread-the-wealth fervor is propagated by lucrative tax shelters. A device that can help relations between labor and management is also one more tool in the Wall Street M&A specialist's kit bag. These facts alone guarantee that ESOPs will keep cropping up in the news.

But don't be misled by what you read. For smaller companies, ESOPs are simply a way of restructuring ownership to provide certain benefits—analogous, in a sense, to going public. As with going public, there are situations in which an ESOP makes sense, others in which it doesn't. And there are certain constraints to be kept in mind as you figure out which camp you fall into. Three rules of thumb:

☐ ESOPs are for well-established, profitable companies. Not tiny businesses; not start-ups; not companies in decline. A company has to be able to afford the costs, and it should be able to take full advantage of the tax breaks. Once in a while an ESOP saves a failing company. Often it only postpones the inevitable.

☐ An ESOP, like a marriage, isn't to be entered into lightly. Yes, you can get liquidity for yourself and financial benefits for your company. But the plans are expensive and cumbersome, and if you don't pay attention to them they can backfire. If you're thinking about establishing an ESOP, talk to a lot of experts and a lot of CEOs who have done it before. There are plenty around.

☐ An ESOP raises expectations among employees. Like former Senator Long, most people take the notion of ownership seriously. If they're treated like owners, they'll respond accordingly, and your company's performance should benefit. If they aren't, they won't, and you'll end up with employee relations no better than before.

Contrary to some of their partisans' hopes, ESOPs aren't likely to dominate the business landscape anytime soon. But neither are they likely to disappear. In the right circumstances—as Henri Bertuch and many other CEOs will testify—they offer benefits that companies and entrepreneurs can't get anywhere else. ☐

Research assistance was provided by Amy Schulman.

BOOK PHOTOGRAPHED BY DILIP CHAUHAN

PENSION RIGHTS CENTER

Mr. Chairman, Members of the Subcommittee, I am Anne Moss, Deputy Director of the Pension Rights Center. I also direct the Center's Women's Pension Project.

The Pension Rights Center is a nonprofit organization that has been working for the past decade to make the nation's pension programs fairer and more responsive to the needs of workers and retirees. We thank you for the opportunity to testify today on a new pension reform proposal, the Pension Portability Act of 1988.

I. Simplified Employee Pensions

Simplified Employee Pension Plans, or SEPs, are the greatest hope that most workers in small companies have for getting a pension at retirement. H.R. 1961 recognizes the importance of SEPs in national retirement income policy by expanding individual rights under SEPs.

Most important, the bill extends to SEP participants the enforcement rights of Title I of ERISA. This means, for example, that a worker whose employer had wrongly failed to make a contribution for her in a particular year would have a right under ERISA to sue her employer. Without Title I protections, her only recourse would be to complain to the Internal Revenue Service which might or might not disqualify the plan.

Another very important ERISA provision extended to SEPs by H.R. 1961 is widow's pension protection. In keeping with the Retirement Equity Act's survivor protections, this bill would require a spouse's consent before a worker could withdraw benefits from a SEP in a form other than a joint and survivor annuity, that is, the automatic form of payment for a married worker would be a pension payable over the two lives of husband and wife. We ask that the bill clarify that the REA's divorce protections also apply to SEPs. This would make explicit that a Qualified Domestic Relations Order could be used to award a share of the SEP to a former spouse.

There are two areas where the bill should be modified to further protect individuals under SEPs.

First, although we are convinced that many small businesses will adopt SEPs once they are educated about their value, these plans will not be widely used until employees themselves start urging their employers to set up SEPs. For this reason, it is important that employees at all income levels be able to expect a SEP to provide a decent retirement benefit. Because lower-paid employees cannot reasonably expect an adequate pension from a SEP integrated with social security, we urge that the bill prohibit integration in employer contributions to all SEPs, not only in contributions to certain salary reduction SEPs.

Second, we urge that the bill be modified to repeal the salary reduction SEP first made available last year under the Tax Reform Act of 1986 to employers with 25 or fewer employees. An employee who works under one of these salary reduction SEPs is likely to receive no benefits unless he or she voluntarily contributes to the plan. Yet the employees who are most in need of a retirement income supplement to their social security will be the least able to make voluntary contributions for retirement.

H.R. 1961 does use a better approach to salary reduction SEPs, that of basing employee contributions on the amounts contributed by the employer. If we are to have SEPs that allow tax deferred voluntary employee contributions, it is certainly preferable as a matter of policy to condition employee contributions on the requirement that the employer contribute first. On the negative side, the H.R. 1961 salary reduction SEP would be available to companies of any size, not just small companies. If anything, the Pension Rights Center would like to see all salary reduction SEPs abolished. We believe that SEPs should be solely employer-paid plans.

II. Portable Pension Plans

The Tax Reform Act added several provisions to the tax code encouraging workers to leave their pension plan benefits for retirement. It generally reduced favorable tax treatment and increased tax penalties for workers who withdraw their pension in a form other than as a monthly benefit starting at retirement age.

H.R. 1961 further encourages the preservation of retirement money by providing for a transfer of funds directly from an employer's plan to a Portable Pension Plan, a trustee-to-trustee transfer. We urge the Subcommittee to modify the bill so that this would be the only way that a lump sum distribution from a retirement plan could be made before age 59-1/2.

We would also like to see the bill clarify that if employers transfer lump sums to Portable Pension Plans for some deferred vested employees, they must make this option available on a uniform basis to all employees.

While the bill addresses the concerns of employers who do not want to retain funds of deferred vested employees, it does not address the critical need of these employees to preserve the real value of their benefits until retirement. The typical worker changes jobs many times during a career. If this worker is fortunate enough to have become vested under a plan, he or she still faces the prospect of collecting a benefit based on wages or salary fixed as of the date the worker leaves the plan. According to one study, a worker who has four jobs, for ten years each, would get about half the pension of the worker who works continuously for forty years on one job (assuming a 6 percent inflation rate and that all plans are identical).

We urge the Subcommittee to study the feasibility of an approach that would provide true pension "portability" by requiring that at the request of deferred vested participants, plans either transfer the present value of their benefits to Portable Pension Plans or, if such a transfer would jeopardize the financial security of the plan, index the participants' deferred vested pensions until retirement age.

The indexing could be along the lines of the British occupational pension scheme, which requires plans to index deferred vested pensions by the lesser of the Retail Price Index or 5 percent. An alternative approach could be a form of "performance indexing" that would require a plan to adjust deferred vested pensions upward only in those years when the plan's rate of return on investments is better than the rate assumed at the time the participant left the plan.

Thank you for inviting us to appear here today. I would be pleased to answer any questions you may have.

STATEMENT OF SENATOR FRANK H. MURKOWSKI (R-AK)
CONCERNING S.2611
AT THE HEARING OF THE COMMITTEE ON FINANCE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

July 12, 1988

I am pleased that the Subcommittee on Taxation and Debt Management of the Committee on Finance has acted expeditiously to consider S.2611. This legislation would provide the Veterans' Administration with a useful and appropriate tool for use in ensuring that needs-based veterans' benefits are paid to the beneficiaries intended by the Congress. It is expected that enactment of this legislation would result in savings to the taxpayer of over $200 million per year by 1992 with no reduction in benefit levels for the veterans and survivors who are the intended beneficiaries of these programs.

The Congress has correctly provided for generous benefits for those who serve our Country in our Armed Forces, as well as their dependents and survivors. These benefits include: a pension for veterans over 65 years of age, or who become permanently disabled due to causes which arise following their wartime service; a pension for the parents of servicemembers who die while on active duty; and a pension for the survivors of wartime veterans who die subsequent to service and due to causes unrelated to their service. These benefits are based on need, that is, eligibility and the amount of the monthly benefit depend upon the income of the recipient.

In addition, a veteran receiving compensation for a disability which arose while he or she was on active duty can receive compensation at the rate for 100% disability, even if the disability is less than 100% disabling, if the disability prevents the veteran for obtaining employment. In some cases, eligibility for free VA medical care depends on the amount of the veteran's income.

For all of these benefits, the income and/or employment of the recipient is a factor in determining eligibility or the amount of the benefit. In all of these cases, the VA depends upon self-reported data provided by the recipient in making eligibility determinations.

In 1985, based on numerous anecdotal reports of abuse of these programs and reports of limited matches of income reported by beneficiaries against income data available from other sources, I asked the General Accounting Office to conduct a general match of income data self-reported by pension recipients against income data provided to the IRS and Social Security Administration by third-party payers such as employers and financial institutions. The GAO needed and obtained special permission from the Joint Committee on Taxation to conduct that match.

The GAO published its findings on March 16, 1988; and, I immediately responded to those findings by requesting that the Committee on Veterans' Affairs report out legislation which would allow the VA to obtain access to the same data for purposes of managing needs based veterans' benefit programs. I am pleased that the Committee responded by reporting out S.2611 which, because it would amend the Internal Revenue Code, has been sequentially referred to the Committee on Finance.

The GAO looked at the records of 1.4 million VA pension recipients and found that 549,000 of them had a total of $947 million in income which was reported for tax purposes but which

had not been reported to the VA for purposes of determining eligibility for veterans' benefits. After limiting itself to discrepancies in excess of $100 the GAO found that VA had made excess payments in one year of over $180 million.
These figures speak for themselves in establishing the need for enactment of S.2611.

In considering this legislation it is important to keep several things in mind.

- This legislation would not eliminate or reduce any veteran's benefit. It merely provides a tool to ensure that recipients receive the amount intended by the Congress.
- This legislation does not depart from existing practice. Other agencies administering needs-based programs already have authority to use this data.
- This legislation does not give the VA access to the individual income tax returns of any individual. The VA would gain access to income and wage data filed by third parties such as employers and financial institutions.
- This legislation protects the privacy and due process rights of the individuals concerned. VA would be required to protect the confidentiality of the information it receives and would be prohibited from taking adverse action until it had notified the benefit recipient of the proposed action, the reason for the action and providing the recipient with an opportunity to respond.

In short, S.2611 provides the Congress with an opportunity to reduce Federal outlays without reducing benefit programs. Opportunities such as this are all-too-rare, and I urge the members of the Committee on Finance to act quickly to bring this legislation before the Senate so that the bill can be enacted in the 100th Congress.

STATEMENT OF
DENNIS E. ROSS
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE FINANCE SUBCOMMITTEE
ON
TAXATION AND DEBT MANAGEMENT

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here to present the views of the Treasury Department regarding the miscellaneous bills that are the subject of this hearing: S.2484 (extension and modification of research credit); H.R.1961 (portability of pension benefits); S.2078 and S.2291 (employee approval of the establishment of employee stock ownership plans); H.R.2792 (tax treatment of Indian fishing rights); S.1239 (treatment of certain short-term obligations in the hands of certain taxpayers); S.2611 (provision of certain tax return information to the Veterans Administration); and S.1821 (exclusion of certain seafood processors from the definition of employee).

RESEARCH CREDIT

Let me turn first to S.2484, the Research and Experimental Credit and Extension Act of 1988, introduced by Senate Finance Committee members John C. Danforth and Max Baucus. Because research spending is essential to fostering technological innovation, which is a major source of growth in productivity, the Administration is committed to encouraging continued growth of private, domestic research activities. To this end, the Administration strongly favors a permanent R&E credit, and supports the efforts of those, such as Senator Danforth and Senator Baucus, who are attempting to improve the effectiveness of the credit.

A. Background: Description of Current Law and S.2484

1. Current Law

The 1981 Economic Recovery Tax Act adopted a 25 percent incremental R&E tax credit "in order to encourage enlarged research efforts by companies which already may be engaged in some research activities." The R&E credit was originally scheduled to expire on December 31, 1985, and it was intended that Congress "have an opportunity to evaluate the operation and efficacy of the credit" before any extension. The 1986 Tax Reform Act (the "1986 Act") extended the credit to December 31, 1988, lowered the rate of credit to 20 percent, restricted the definition of eligible expenditures, and included the credit in the general business credit limitation.

Under section 41 of the current Code, a 20 percent tax credit is allowed for a certain portion of a taxpayer's "qualified research expenses." The portion of qualified research expenses that is eligible for the credit is the excess of the current year's qualified research expenses over the base amount. The base amount is the average annual amount of qualified R&E expenditures over the prior three years (or if the firm is not in existence for three years, the average of the expenditures for its years in existence). This base, however, is subject to the limitation that it never be less than 50 percent of current qualified expenditures.

The 1986 Act also established a separate 20 percent tax credit ("the University Basic Research Credit") for corporate funding of basic research through grants to universities and other qualified organizations performing basic research. The

University Basic Research Credit applies to the excess of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research over (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, adjusted for inflation.

In general, qualified expenditures consist of (1) "in-house" expenditures for wages and supplies used in research; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) certain time-sharing costs for computers used in research. Restrictions adopted in the 1986 Act further limit the credit to expenditures for research that is technological in nature and that will be useful in developing a new or improved business component. In addition, certain research is specifically excluded from the credit, including research performed outside the United States, research relating to style, taste, cosmetic, or seasonal design factors, research conducted after the beginning of commercial production, research in the social sciences, arts, or humanities, and research funded by a person other than the taxpayer.

The credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. With one exception, relating to certain research joint ventures, the "trade or business test" for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. As a result, new corporations and corporations entering a new line of business cannot claim the credit for qualifying R&E expenses because the expenses do not relate to an ongoing trade or business.

The R&E credit is aggregated with certain other business credits and subject to a limitation based on tax liability. The sum of these credits may reduce the first $25,000 of regular tax liability without limitation, but may offset only 75 percent of any additional tax liability. Taxpayers may carry credits not usable in the current year back three years and forward fifteen.

The Ways and Means Committee has tentatively agreed to extend the present-law credit for two years. Thus, the credit would apply to qualified research costs paid or incurred on or before December 31, 1990. To offset some of the revenue cost of the two-year extension, the Committee also agreed to reduce deductions under section 174 by the amount of the taxpayer's section 41 credit allowed for the taxable year.

2. Description of S.2484

S.2484 is designed to increase the R&E credit's incentive effect and to increase the number of taxpayers that are eligible for the credit. S.2484 would retain the incremental feature of the present credit and its 20 percent rate, but would make the credit permanent and modify calculation of the base amount. The new base would be a fixed historical base equal to the average of the firm's qualified R&E expenditures for 1983-1987 and would be indexed annually by the average increase in gross national product (GNP). In addition, in 1989 the base would receive a one-time upward adjustment of seven percent (in order to make the base revenue-neutral with respect to earlier proposals with a three-year base). Firms also would have the option of a separate seven percent credit for expenditures over 75 percent of the base amount. As with current law, all firms would be subject to a 50 percent base limitation.

Under the proposal, the "trade or business" test would be made less stringent so that new firms and firms entering new lines of business could claim the credit without regard to the trade or business test if the taxpayer intended to use the results of the research in the active conduct of a present or future trade or business. The credit would not be available, however, for research undertaken for investment rather than business purposes. Thus, research intended solely to be licensed to unrelated parties for use in their businesses would not be eligible for the credit. In addition, the liberalized trade or business rules would apply only to in-house research and not to research contracted out to unrelated parties. S.2484 also contains special rules for calculating the base for start-up firms.

B. Evaluation of the Danforth-Baucus Bill (S.2484)

1. Summary Evaluation

Prior Treasury testimony before this Subcommittee has described certain weaknesses in the structure of the current R&E credit. While continuing to believe that the R&E credit is an important stimulant for economic growth and productivity, we have also studied ways to restructure the credit so as to increase its incentive effect. The Danforth-Baucus proposal is consistent with our own views regarding the optimal credit structure, and we believe it can have a significant effect in encouraging R&E. Accordingly, the Treasury strongly supports the basic structure and design of the credit proposed in S.2484.

The President has proposed a permanent R&E credit in his 1989 budget at a revenue cost equal to an extension of the current credit. Although the Administration's first priority is to prevent expiration of the credit, we would support an R&E credit as modified in the Danforth-Baucus bill if the proposal were made revenue-neutral to an extension of current law. As I will discuss later, we believe the revenue cost of the Danforth-Baucus bill can be reduced while maintaining the bill's important structural improvements to the credit.

The R&E credit proposed in the Danforth-Baucus bill has several advantages: (1) it greatly increases the incentive of the R&E credit both in absolute terms and per dollar of credit; (2) it increases the percentage of R&E-performing firms that are eligible for the credit; (3) it eliminates the relationship between the availability of the credit and the rate of inflation; (4) it extends to new firms R&E incentives which had previously been available only to established firms; and (5) it makes the credit permanent. I will discuss each of these advantages in turn.

2. Incentive Effects

The most important feature of the Danforth-Baucus credit is the replacement of the current credit's moving-base with a fixed-base structure. We believe the fixed-base structure results in a five-fold increase in the credit's incentive effect per dollar of revenue cost.

It is now widely acknowledged that an incremental credit with a base equal to a moving average of previous expenditures leads to an effective rate of credit which is only a fraction of the statutory rate. A credit's effective rate is the effective reduction in price of the last or marginal expenditure undertaken by any firm and is a measure of the credit's incentive effect. Treasury analyses, as well as other studies, indicate that the average effective rate of the current R&E credit is about two percent. Thus, the credit on average provides the same incentive as a two percent price reduction on R&E expenditures. This relatively small effect is again primarily attributable to the moving base, since additional R&E in one year increases the base and effectively decreases the credit in subsequent years. Thus, R&E generating a dollar credit in the first year will cause a 33.3 cent reduction in credit in each of the following three years, so that the credit's only benefit to a firm is a deferral rather than a reduction in taxes.

In some situations the moving base can actually turn the effective rate of credit negative, so that the credit encourages a firm to reduce R&E expenditures. This occurs both when a firm is growing slowly and current R&E expenditures are below base and when a firm is growing quickly and is subject to the 50 percent base limitation. For firms below base, negative effective rates of credit result because marginal increases in R&E yield no credit but reduce credits in future years. For firms subject to the base limitation, negative effective rates of credit result because each 50 cents of credit earned in the current year is followed by 33.3 cents less of credit in each of the following three years.

The Danforth-Baucus bill would address both the low and negative incentive problems by adopting a base equal to an average of 1983 through 1987 expenditures, adjusted upward by seven percent, and (to maintain relatively even revenue costs over time) indexed to nominal GNP. The critical feature of this so-called "fixed" base is that a firm's current spending will have no effect on future credits. Thus, unlike the current credit, a dollar of credit earned in the current year does not reduce credits in the following year. Under the Danforth-Baucus bill, firms eligible for a 20 percent credit on average receive the incentive equivalent to nearly a 20 percent reduction in price. Taxable high-growth firms facing the 50-percent base limitation have an effective rate of credit equal to 10 percent. Even low-growth firms on the alternative seven percent credit receive twice the incentive of that provided by current law.

3. Growth and Eligibility for the Credit

The Danforth-Baucus bill would also significantly increase the percentage of R&E-performing firms eligible for the credit. This increase is achieved through the design of the primary and alternative bases, which results in a larger number of firms with R&E expenditures above base.

The limited availability of the current credit to firms performing R&E is too often overlooked. High rates of R&E growth in the early 1980s (due both to real growth and to inflation) minimized the problem because inflation kept many slow-growing firms from falling below base. A slowdown in R&E growth in the late 1980s, however, has made it increasingly apparent that an increase in availability of the credit would improve its effectiveness.

The goal of a tax credit for R&E is to encourage a firm to invest in R&E at a level higher than it would absent the credit. In economists' jargon, the credit is designed to increase marginal expenditures. In the absence of a credit, all firms determine their optimal amounts of R&E spending by weighing costs against potential benefits. If it were known that each firm would spend $X in the absence of a credit, the most efficient credit would provide a tax reduction to all firms for expenditures above their respective $X amounts. Although there has been much debate about how the credit should be distributed among firms with high, low or negative growth in R&E, the credit is most effective if it encourages all firms, regardless of whether their $X amount is declining or increasing, to increase R&E investments.

Unfortunately, the $X amount for every firm cannot be accurately determined and in designing a credit base some judgment must be made about the behavior of firms with respect to R&E expenditures. The three-year moving base of the current R&E credit assumes that firms steadily increase R&E investment over time, so that their $X amount is always in excess of prior years' expenditures. Although this model may reflect the usual behavior of larger firms, which tend to show steady growth in R&E, smaller firms have more varied spending patterns. Small firms may have only one or two research projects for which optimal expenditures may increase or decrease greatly, depending on the particular phase of the research cycle that is faced in the current year. Both Treasury studies and a recent General Accounting Office study indicate that the moving-base of the current credit result in approximately one-third of all R&E-performing firms being ineligible for the credit in any one year.

There are, of course, some trade-offs involved in designing a credit base so as to improve the availability of the credit. Lowering the credit base so as to increase the credit's availability comes at the price of increasing the amount of credit to all firms or lowering the rate of credit. At one extreme, the base could be set at zero and all firms would be eligible for the credit; but such a credit at a 20 percent rate would be extremely expensive. Increases in the base save revenue, but, of course, decrease availability. Although no credit base can achieve optimal levels of availability at acceptable revenue costs, the two-tiered credit of the Danforth-Baucus bill significantly increases the credit's availability without substantially expanding the credit's revenue cost.

4. Inflation

Under S.2484 the credit base is indexed to GNP. As a result, the amount of the credit allowable to any firm and the cost of the credit to the government no longer depends on the rate of inflation. In this way, the credit is provided only for real increases in R&E spending. By contrast, under the current credit structure, the availability of the credit, the amount of credit, and the revenue loss from the credit are positively related to the rate of inflation. This is undesirable as a matter both of tax and economic policy.

From a tax policy standpoint, the incentive effects of the credit are diminished since the amount of the credit available to the taxpayer depends on the variable of inflation. There is similarly uncertainty as to the credit's total cost to the government.

The effect of inflation on the credit also has a perverse macroeconomic effect. Since inflation is usually associated with strong aggregate demand, the incremental credit has the opposite effect of an automatic stabilizer: it encourages increased business spending during economic expansions and decreased spending during recessions.

As noted above, the Danforth-Baucus proposal provides a credit insulated from the effects of inflation. Because the base is indexed to nominal GNP growth (which includes inflationary as well as real growth), firms are not unduly rewarded for growth in qualified expenditures due to inflation nor are they penalized for slowdowns in the rate of inflation. The revenue costs of the Danforth-Baucus proposal are therefore much less dependent upon the rate of inflation than the current credit. Furthermore, because the amount and availability of the credit is much more certain, its incentive effect per dollar of revenue cost is larger.

5. Entry into New Markets and Eligibility for the Credit

S.2484 greatly expands the number of firms eligible for the credit by allowing new firms and firms beginning a new line of business to claim the credit for qualifying R&E expenses that relate to the active conduct of a present or future trade or business. Under current law, a new firm or a firm entering a new line of business may not earn credits until qualified expenses are incurred "in carrying on" a trade or business. Since it may be several years between initial research expenditures and the sale of products resulting from such expenditures, the tax system puts start-up firms at a competitive disadvantage vis-a-vis established firms who are already "carrying on" a trade or business.

The Danforth-Baucus proposal would allow expenditures of new firms and firms entering new lines of business to claim the credit without regard to the trade or business test if the taxpayer intends to use the results of the research in the active conduct of a present or future trade or business. Thus, a firm that intends merely to lease or license the results of research would continue to be ineligible for the credit.

6. Permanency of the Credit

S.2484 makes the credit permanent, which we strongly support. The ability of the credit to induce additional R&E expenditures depends directly on its availability at the time firms are planning R&E projects and projecting costs. R&E activity, by its nature, is long-term, and taxpayers should be able to plan their research activity with certainty that the credit will be available. Thus, if the credit is to have the intended incentive effect, the R&E credit must be made permanent.

7. The University Basic Research Tax Credit

We also support the provision in S.2484 that extends the University Basic Research Credit along with a general R&E credit. This provision was first available to taxpayers as a result of the 1986 Act, and its structure should be reviewed for possible modification once tax return data and other evidence is available. At this time, however, it appears that the University Basic Research Credit provides an important incentive to basic R&E activities that are critical to this country's economic future.

8. Suggested Modifications to the Danforth-Baucus Proposal

As I stated earlier, we strongly support the structural changes in the R&E credit proposed in the Danforth-Baucus bill. Our full support for the legislation, however, would require that its revenue cost be limited to that of the current R&E credit. We believe that this revenue objective can be obtained without sacrificing the bill's structural improvements to the R&E credit.

In our view, the best way to limit the revenue cost of the Danforth-Baucus credit is to reduce a taxpayer's section 174 research deductions by the amount of credit taken. Such a reduction of deductible expenses currently exists for the rehabilitation tax credit and the targeted jobs credit. Similarly, a reduction of depreciable basis equal to 50 percent of the investment tax credit existed before it was repealed by the Tax Reform Act of 1986.

Disallowing a deduction for R&E expenses to the extent of R&E credits would treat all sources of Federal support for R&E similarly for tax purposes. The Federal government supports research indirectly through grants and tax credits. Although a tax credit is economically equivalent to a grant (but administered through the tax system), tax credits and grants have different tax treatment. Research costs funded through grants are not deductible while research costs offset by credits are fully deductible. Disallowing the deduction of expenses attributable to credits would rationalize the current budget accounting for alternative funding sources for research by measuring both direct subsidies and tax expenditures for R&E in pre-tax dollars.

For example, Firm A conducts $100 in qualifying research and receives $20 from the government as a 20-percent matching grant. Under current law, Firm A is entitled to deduct only the $80 R&E expenses it actually incurred. By contrast, Firm B conducts $100 of research and receives $20 of tax credit rather than a $20 grant. Under current law, Firm B is entitled to deduct the entire $100 of R&E expense even though the $20 tax credit to Firm B is equivalent to $20 grant received by Firm A.

I should emphasize that our support for disallowance of R&E expenses by the amount of the R&E credit is tied to adoption of the balance of the Danforth-Baucus bill. Although this deduction disallowance has a sound tax policy basis, as a practical matter it is a reduction in the statutory rate of the credit.1/ As part of the Danforth-Baucus proposal, this reduction is more than offset by other improvements in the credit. We would not support it, however, were it proposed as part of an extension of the existing R&E credit.

To further improve the distribution of the credit while maintaining revenue neutrality with respect to extension of the current credit, the Treasury also recommends replacing the seven percent upward adjustment of the fixed base with a two percent adjustment. The revenue cost, incentive effect, and percentage of firms eligible for credit under the Danforth-Baucus proposal with Treasury's suggested revenue-preserving modifications are shown in Table 1.

1/ The deduction disallowance effectively reduces the credit by the tax rate, 34 percent, resulting in an effective credit rate of approximately 13.2 percent.

TABLE 1

Summary of R&E Credit Stuctures with Permanent Extension

Proposal	Revenue Cost Over Fiscal Years 1989 Through 1993	Incentive: Increase in R&E Per Dollar of Revenue Loss	Availability: Percentage of Firms Earning Credit
(1) Ways and Means Credit	$ 3,162 mil.	$ 0.20	67.5 %
(2) Extension of Current Law	$ 4,791 mil.	$ 0.20	67.5 %
(3) Danforth-Baucus R&E Credit	$ 6,459 mil.	$ 1.21	74.9 %
(4) Proposed Treasury R&E Credit	$ 4,865 mil.	$ 1.11	77.8 %

TABLE 2

Revenue Cost of R&E Credit Proposals Under Two-Year, Three-Year, and Permanent Extensions

Proposal	Revenue Cost (millions of dollars) 1989	1990	1991	1992	1993	5-Year Total
	(fiscal years)					
(1) Ways and Means Proposal						
(a) Two-year Extension	265	538	361	139	93	1395
(b) Three-year Extension	265	538	675	438	191	2107
(c) Permament Extension	265	538	675	789	896	3162
(2) Extension of Current Law						
(a) Two-year Extension	401	815	547	211	140	2114
(b) Three-year Extension	401	815	1023	664	290	3193
(c) Permament Extension	401	815	1023	1195	1357	4791
(3) Danforth-Baucus Credit						
(a) Two-year Extension	510	1059	713	276	182	2740
(b) Three-year Extension	510	1059	1357	886	385	4196
(c) Permament Extension	510	1059	1357	1627	1906	6549
(4) Treasury R&E Credit						
(a) Two-year Extension	390	809	544	210	139	2092
(b) Three-year Extension	390	809	1028	667	291	3184
(c) Permament Extension	390	809	1028	1220	1418	4865

PENSION PORTABILITY: H.R.1961

A. Background

The issue of pension portability is a complex one, which warrants serious and in-depth study by Congress, the Treasury Department, the Department of Labor and other policymakers. Prior to addressing H.R.1961, therefore, I would like to discuss the issue in general terms, in order to identify the basic sources of qualified plan benefit losses attributable to employees changing employers, the difficulties associated with increasing portability and the portability effects of some of the recent, major legislative changes in the pension area.

1. Portability Under the Current Retirement Plan System

The issue of pension portability has often been viewed narrowly as whether employees can "take" their full vested benefits with them when they leave employers and invest them in other plans or individual retirement accounts (IRAs). This view of portability is often referred to as portability of assets or cash values. Other common views of pension portability have included portability of benefits and portability of service. Portability of benefits refers primarily to vesting and other eligibility conditions (e.g., age and service conditions applicable to early retirement subsidies) that may cause mobile employees to lose pension benefits when they lose jobs. Finally, portability of service refers generally to the recognition under a defined benefit plan, for participation, vesting, and benefit accrual purposes, of an employee's service for employers other than the employer maintaining the plan. More recently, commentators have begun to believe that while the concept of portability includes these particular issues, it actually may be a much broader concept that touches on many of the basic features of our voluntary, employer-based private pension system.

Viewed more broadly, pension portability refers to the differential between the total pension benefit that a short-term, mobile employee receives for a working lifetime with many employers and the total pension benefit that a long-term employee receives for the same working lifetime with a single employer. This benefit differential is often referred to as a portability loss. Because many workers do not remain with a single employer for their entire working lifetimes, or in many cases even for their last 15 working years, portability actually reflects a concern about whether sufficient numbers of this nation's workers receive meaningful retirement benefits under the private pension system. Also, portability reflects a concern about whether the tax benefits associated with the private system are fairly distributed among various groups of workers--for example, mobile and long-term employees, young and old employees, highly compensated and non-highly compensated employees, and women and men.

Under current law, two employees may start out at equal jobs, do an equal amount of work, and receive the same amount of cash pay, but, under the voluntary, employer-based pension system, they may receive very different levels of pension benefits for the same amount of work. If women shift employment more often than men, for instance, they will receive smaller total pensions at retirement for the same number of years of work. The extent of these portability losses will depend upon many factors, including, for example, the future rate of inflation.

The issue of portability centers broadly on what is considered a "fair" differential of lifetime pension benefits between mobile and less-mobile workers. If one tries to determine what is "fair" by examining the pension rules established by Congress, it is difficult to come to a conclusion. For example, under the typical defined contribution plan, fairness generally is determined by providing employees with contributions that are an equal proportion of current pay. Under a typical defined benefit plan, however, "fairness" is often based on the provision of an equal replacement rate on a service and pay base approximating final salary or salary in the employee's peak earning years.

While these defined contribution and defined benefit formulas might sound similar in concept, in practical terms they can have enormously different impacts on mobile employees relative to long-term employees. Defined benefit formulas often result in little or no real accrual of benefits to the mobile employee, especially in their young and middle years. Moreover, these formulas produce benefits that are much more subject to the vagaries of such factors as inflation. For example, although the typical defined benefit formulas may at low inflation rates strike an appropriate balance between mobile and long-term workers, at higher inflation rates these formulas may excessively favor the long-term workers.

In evaluating portability issues and proposals, one should recognize that pension benefit differentials between mobile and long-term employees do not always reflect market failures or imply that certain groups of employees are being treated unfairly in the larger perspective. Such benefit differentials may to an extent be the result of appropriate employer decisions to maintain plans providing different amounts or forms of pension benefits and of appropriate employee decisions to seek employment offering different mixes of pension benefits, cash pay, and other benefits.

For example, employers requiring specially skilled workers may well prefer to link pension benefits to length of service, such as through deferred vesting or deferred benefit accruals, in order to retain such skilled workers. Other employers requiring employees with more general skills, however, may have less incentive to reward employees to stay for longer periods of time. Similarly, for a variety of reasons (e.g., need for cash income or other benefits), employees may appropriately select jobs offering different levels of pension benefits. Also, to gain the greater benefit security offered by properly funded and PBGC-insured defined benefit plans relative to defined contribution plans, employees may favor employment providing defined benefit plan coverage over employment with an employer that maintains only a defined contribution plan.

In this setting, it is important that employees have a better understanding of their benefit entitlements and rights under defined benefit plans and defined contribution plans. Informed employees should be better able to make employment decisions and bargain more effectively over the desired mix of cash compensation and pension benefits.

The following discussion surveys the basic features of the voluntary, employer-based private pension system that may contribute to pension portability losses for mobile workers.

a. Gaps in Pension Coverage

Differentials of pension benefits between long-term workers and mobile workers may first occur because not all employers maintain qualified plans and those employers that do maintain plans do not necessarily cover all of their employees. Thus, many mobile employees are likely not be covered under qualified plans for some portion of their working lifetimes.

Gaps in pension coverage generally are more common among lower-paid workers in part because such workers may value retirement benefits relative to cash compensation less than do higher-paid workers. Nondiscrimination rules for qualified plans, however, for broad social and tax equity reasons, require employers to provide a portion of their lower-paid employees with comparable pension benefits. Nevertheless, some disparity of pension coverage is allowed to exist in favor of higher-paid employees. For example, under current law, an employer that provides pension benefits to 100 percent of its highly compensated employees (generally, employees who have at least a five percent ownership interest in the employer and employees who earn over $50,000) need provide comparable pension benefits to only 70 percent of the employer's non-highly compensated employees.

Furthermore, it is common even for employers that maintain broad-based qualified plans to exclude newly hired employees from plan coverage until the employees have performed at least one year of service for the employer. Thus, to the extent mobile employees fail to stay with employers for at least one year, they commonly do not earn any pension benefit. Thus, their total working years commonly will exceed the total years of pension coverage by at least the total number of jobs.

In the 1986 Act, the pension coverage rules were modified to increase the extent to which an employer's low- and middle-income employees must be provided comparable qualified plan benefits. For example, under the pre-1986 Act rules, a pension plan could qualify for tax-favored status if it covered a reasonable classification of employees. While there is always doubt whether a coverage classification is reasonable, in certain circumstances a classification including 100 percent of an employer's highly compensated employees and only 20 percent of the non-highly compensated employees could qualify as reasonable. Under the 1986 Act rules, not only must a pension plan cover at least a reasonable classification of the employer's employees, but also all of the non-highly compensated employees of the employer must receive, on average, pension benefits that are at least 70 percent of the average pension benefits received by the employer's highly compensated employees.

While gaps in pension coverage have contributed to mobile employees' portability losses, research to date has not indicated the frequency with which such gaps lead to major benefit differentials between mobile and long-term employees. Also, the extent to which the coverage changes adopted in the 1986 Act will affect portability losses is as yet uncertain as the new rules only go into effect in 1989.

b. Disparities in Benefit Levels

Even if a mobile employee is covered under an employer's qualified plan, portability losses for mobile workers may occur because employers do not all maintain qualified plans that provide comparable levels of benefits. For example, one employer may provide its employees with coverage under a defined contribution plan that provides an annual contribution of five percent of current compensation, while another employer maintains a 10 percent defined contribution plan or a defined benefit plan that provides a retirement benefit of 1.25 percent times years of service times the employee's final pay. In the voluntary, employer-based private pension system, there are numerous differences in the benefit levels provided under the various types of qualified plans. Indeed, one of the premises of our voluntary pension system is that an employer should have the flexibility to set an affordable and appropriate level of benefits for its workforce.

In fact, while these disparities in benefit levels contribute to differences in benefits among employees, it is not clear that this factor per se would create a greater likelihood that a mobile employee would incur a portability loss.

c. Deferred Vesting

Even if a mobile employee earns a meaningful level of pension benefits under a qualified plan, the plan may require that the employee perform a minimum number of years of service before vesting in his benefit. Beginning in 1989, the tax law permits a plan to defer an employee's vesting in his earned benefits until he has performed at least five years of service (ten years in the case of a collectively bargained, multiemployer plan). Obviously, mobile employees will more often fail to stay with employers for the period necessary to vest in their pension benefits and thus will more frequently suffer portability losses due to deferred vesting.

In many cases, deferred vesting may also work to the disadvantage of the lower-paid employees. To the extent that low- and middle-income workers change jobs more frequently than higher-paid employees, the lower-paid mobile workers are more likely to lose accrued benefits due to inadequate vesting service, just as they are more likely not to accrue benefits due to gaps in pension coverage and lower levels of benefits.

In the 1986 Act, the pension vesting rules were modified generally to reduce the number of years of service that a plan could require an employee to complete before vesting. Before the

1986 Act, for example, a plan could defer vesting until an employee had performed ten years of service. The 1986 Act reduced the years of service that a plan could require for full vesting from ten to five years (except that multiemployer plans still may require ten years of service).

It is difficult at this time to assess fully the effect of the 1986 Act vesting changes on portability since these changes are not effective until 1989. However, it is clear that fewer employees will incur portability losses under the 1986 Act rules. While five-year vesting will still contribute to some employees' benefit losses, existing evidence does not indicate that it is a major factor in causing significant portability losses among mobile employees.

d. Deferral of Pension Benefit Accruals

Portability losses for mobile workers typically occur under those pension plans that use contribution or benefit formulas based, in whole or in part, on an employee's years of service or final pay with the employer. Under such formulas, as an employee accumulates additional years of service and approaches retirement age, the employee earns pension benefits representing increasing percentages of the employee's final pay immediately preceding retirement. Thus, by producing a pattern of deferred benefit accrual over an employee's working lifetime, these formulas provide longer service employees and employees closer to retirement with larger benefit accruals than short service, more mobile, and younger employees.

For example, assume that a mobile employee earns 40 years of pension benefits with four employers (ten years with each employer) under identical defined benefit plans that base benefits on the employee's final pay with the employer. The total pension benefit earned by this employee will be significantly smaller than the total benefit earned by an employee who earns all 40 years of benefits under an identical defined benefit plan with a single employer. This is because none of the plans base their benefits on the employee's years of service with prior employers or on the employee's compensation with subsequent employers. Indeed, very few of the defined benefit plans in the private system (other than collectively bargained, multiemployer plans) grant credit for service or pay with other employers.

Service- and final-pay-based benefit formulas are most common among defined benefit plans. Indeed, even defined benefit plans with career average pay benefit formulas generally defer benefit accruals because benefits under such plans are often regularly improved or updated to reflect employees' pay as of the update. However, some defined contribution plans, such as target benefit plans and plans that allocate greater contributions to employees with additional years of service, exhibit the same pattern of deferred benefit accrual.

In addition to the deferred benefit accrual that naturally occurs under service- and final-pay-based benefit formulas, some defined benefit plans also permit long-service employees who retire at an early retirement age (often, age 55) to receive an additional generous pension benefit. Thus, for example, a defined benefit plan may provide that an employee who retires with at least 25 years of service at age 55 will receive the same annual benefit that he had earned for commencement at age 65. In effect, this early retirement benefit can be a very valuable, deferred benefit for employees who retire at age 55 with at least 25 years of service.

The portability effect of deferred accruals, then, is similar to the effect of deferred vesting. The value of the lost benefits due to deferred benefit accruals, however, is generally much greater than the value of the lost benefits attributable to an employee's first few years of service. Thus, deferred accruals may cause long-service and older employees to receive significantly greater pension benefits than the more mobile, younger employees. Also, the extent of the significant benefit differential resulting from deferred accruals is dependent on the level of inflation, and does not depend solely on real wage growth. Finally, to the extent that lower-paid workers turn over more rapidly than higher-paid employees, deferred accruals result in the lower-paid employees accruing less than comparable pension benefits than long-service employees over the same working lifetime.

e. Pre-Retirement Benefit Erosion

Some commentators argue that the issue of portability involves not only differences in vested pension benefits earned by mobile and long-term workers, but also differences in the pension benefits ultimately received at retirement. That is, portability problems can result not only from a mobile employee's failure to accrue a benefit, but also from the failure to preserve an accrued benefit as a retirement benefit.

Defined benefit plans generally may not make benefit distributions available to an employee before the employee either terminates employment with the employer or attains retirement age under the plan. Mobile workers will have more opportunities to receive pre-retirement benefit distributions than will long-term employees. Research indicates that, particularly for younger employees, high percentages of pre-retirement distributions are used for nonretirement purposes, rather than rolled over to IRAs or other plans. Thus, mobile employees generally incur greater reductions in their ultimate pension benefits through pre-retirement benefit distributions. Note, however, that except for foregone tax advantages, this factor does not imply that mobile employees receive less compensation from employers, only that they consume their pension benefits earlier.

The 1986 Act adopted various rules designed to reduce the extent to which pension benefits are consumed before retirement. The Act applied a 10 percent early distribution tax, eliminated special ten-year averaging for pre-retirement lump-sum distributions, and adopted a pro rata basis recovery rule for qualified plans. These changes are likely to reduce the level of pre-retirement benefit erosion by encouraging mobile employees who do receive pre-retirement distributions to preserve their benefits in IRAs and other plans for retirement.

2. General Problems with Portability Proposals

No matter how attractive the portability label may be, proposals intended to promote portability must be carefully evaluated in light of several important objectives: increasing savings; promoting an efficient allocation of resources; distributing fairly the significant tax benefits associated with private pension plans; and providing meaningful private pension benefits to low- and middle-income employees. As discussed above, in evaluating portability proposals, one should remember that pension benefit differentials between mobile and long-term employees may be the result of appropriate employer decisions to maintain plans providing different amounts or forms of pension benefits and appropriate employee decisions to seek employment offering different mixes of pension benefits, cash pay, and other benefits.

Features of the voluntary, employer-based, tax-qualified pension system that contribute to portability losses may also provide important benefits more consistent with the objectives set forth above. For example, it is difficult to expand coverage or improve benefit levels without also either creating disincentives for employers to maintain qualified plans by increasing employer costs or threatening the voluntary nature of the system (e.g., mandating employer-provided pensions). Also, some employers and employees may have non-tax and non-pension preferences that may justify some benefit differentials. Finally, proposals to encourage the maintenance of additional qualified plans that provide more meaningful levels of retirement benefits within the context of the voluntary system are likely either to have revenue costs or to affect adversely benefit funding or discrimination.

a. Benefit Indexing

Those who criticize the portability effects of deferred benefit accruals often suggest indexing an employee's benefit for years between pre-retirement termination of employment and the employee's retirement age. Such indexing could be based on price or wage growth and is aimed at giving an employee credit for future pay increases with subsequent employers. However, indexing either would substantially increase the cost of maintaining defined benefit plans or result in reductions in the ultimate pension benefits for long-service employees and employees who commence employment fewer than ten or fifteen years before retirement.

b. Mandating Prior Service Credit

Another approach to addressing the portability losses of deferred benefit accruals is to mandate that defined benefit plans credit an employee's years of service with all prior employers and then to permit such plans to offset employees' pension benefits by the benefits provided by the prior employers. This approach would impose significant costs on employers that maintain defined benefit plans and thus would likely encourage employers to stop providing defined benefit plan coverage. In many ways, this approach would be impractical given the wide differences among the types of plans and could significantly deter employers from hiring older employees.

c. Deferred Accruals May Benefit Mobile Employees

To further complicate the analysis regarding the portability effects of deferred benefit accruals is the view that plans providing deferred accruals actually may be beneficial to mobile employees. By working the last ten or fifteen working years under a plan that defers employees' benefit accruals to the years approaching retirement age, a mobile employee is able to earn a significant portion of the pension benefits he would have earned if he had stayed with a single employer. Under the voluntary, employer-based private pension system in an economy where mobility is common, many workers will earn no or very small pension benefits for at least some of their years of employment. Indeed, during certain periods of their lives, some employees will opt for employment that maximizes their cash compensation in lieu of pension benefits. The availability of plans that defer benefit accruals to the years approaching retirement thus gives many employees the opportunity to "catch up" on earning pension benefits at the end of their working lifetimes.

Thus, one must balance the adverse portability effects of deferred benefit accruals with other important economic, tax, and retirement objectives. Given the ability of final pay defined benefit plans to produce a meaningful retirement benefit for an employee, including a low- or middle-income employee, over his last ten or fifteen working years, there is no single factor by which to determine when an appropriate balance has been achieved.

d. Other Portability Proposals

Other proposals have been made to address pension portability. For example, as discussed, minimum coverage and vesting requirements for qualified plans may have some effect on portability losses. Some proposals would facilitate or encourage tax-free benefit rollovers and transfers among IRAs and retirement plans (e.g., increases in the early distribution tax), while others at least would permit employees who have made after-tax employee contributions to plans to transfer such contributions to IRAs and other retirement plans. Of course, there are significant questions about the extent to which these proposals meaningfully would improve pension portability. Also, these and other proposals must be evaluated not only in light of their purported portability effects, but also in light of the important economic, tax, and retirement objectives outlined above.

3. Description of H.R.1961--Pension Portability Act of 1988

H.R.1961, the Pension Portability Act of 1988, proposes to make various changes to the qualified plan and IRA rules in an attempt to promote the portability of pension benefits. In general, H.R.1961 would provide that (i) in certain circumstances, a plan would be required to make the direct transfer of an employee's pension benefits to an IRA the primary form of benefit distribution; (ii) the Secretary of the Treasury could permit employees to roll over to IRAs their after-tax employee contributions to qualified plans; (iii) IRA amounts transferred from qualified plans would be subject to the spousal protections applicable to defined contribution plans; (iv) IRA trustees would be required to make IRA-to-IRA transfers within 10 days of receipt by the trustee of the IRS owner's transfer request; and (v) employers that do not maintain pension plans would be able to maintain an alternative salary reduction form of simplified employee pension (SEP). These changes would not become effective until 1992.

B. Discussion

In our view, the major feature of the bill likely to facilitate portability is the rule permitting plan-to-IRA transfers of after-tax employee contributions. Under current law, because after-tax employee contributions may not be rolled over or transferred from qualified plans to IRAs, in many cases employees are not able to preserve these amounts in tax-favored retirement vehicles.

Most of the other features appear to be intended to provide employers with greater authority to move the qualified plan benefits of employees who have terminated employment to IRAs without employee consent. At best, these features would be neutral with respect to portability issues. In fact, some of these features would merely relieve employers of administrative burdens at the risk of reducing some of the rights and benefits that employees and their spouses would otherwise enjoy if their benefits remained in the employer's plan.

The alternative salary reduction SEP generally is a SEP design that many employers could adopt on their own under the salary reduction SEP rules currently in effect. But H.R.1961 makes the salary reduction SEP available to employers of all sizes--current law limits salary reduction SEPs to employers with fewer than 25 employees--so long as the employers do not maintain other qualified pension plans. However, it appears that H.R.1961 attempts to expand pension coverage through salary reduction SEPs, in part, by applying nondiscrimination rules that are more relaxed than the rules applicable to similar tax-favored arrangements, such as cash or deferred arrangements under section 401(k). In our view, employers should not be able to avoid the generally applicable nondiscrimination rules simply by providing tax-favored pension benefits through a particular form of plan, such as SEPs; tax-qualified retirement plans should be subject to a consistent set of nondiscrimination rules.

We recognize that, despite recent legislative changes, portability remains a very important issue that affects millions of Americans and that the current pension system could be improved to reduce portability losses. In this connection, we believe that many of the legislative proposals under consideration, including H.R.1961, make important contributions to the continuing dialogue on portability. However, they must be evaluated in light of the important economic, tax, and retirement objectives previously discussed. Also, in recent years, the private retirement system has been the subject of several significant, positive legislative changes which many employers and benefit advisors have yet to fully digest. Time is needed to properly assess the portability effects of these recent changes to the pension law, many of which only become effective in 1989.

EMPLOYEE APPROVAL OF THE ESTABLISHMENT OF EMPLOYEE STOCK OWNERSHIP PLANS: S.2078 and S.2291

A. Background

An employee stock ownership plan ("ESOP") is a qualified pension plan designed to invest primarily in employer securities. An ESOP is a "defined contribution" type of qualified plan. In a defined contribution plan, an employee's benefit is equal to the value of the contributions and other amounts allocated to the employee's account under the plan, adjusted for investments gains and losses. Assets of a defined contribution plan are generally invested by the plan trustee either in a diversified portfolio of investments or according to participants' directions. Because employees' benefits are directly dependent on the value of the plan's assets, employees bear the risk of investment experience. Under an ESOP, employees' benefits are directly dependent upon the success and profitability of their employer because the assets of an ESOP are primarily invested in employer securities. Thus, the investment risk borne by ESOP participants is greater than the risk borne by participants in other types of defined contribution plans.

Significant tax preferences are available for ESOPs and transactions involving ESOPs. All of the tax preferences available for defined contribution plans are available for ESOPs. This is so even though ESOPs are not solely retirement plans and the tax preferences exist to encourage employers to provide employees retirement income benefits. These tax preferences permit a corporation maintaining an ESOP to receive a current deduction for its ESOP contributions and provide that plan participants are not taxed on their benefits until they are distributed. Many additional tax preferences are available, some of which simply increase the preferences available generally to defined contribution plans and others which reflect the nonretirement features of ESOPs. One often stated justification for these additional preferences is that ESOPs provide employees an equity ownership interest in their employers and, thus, increase employee productivity and company profitability.

The increased tax preferences available for ESOPs are larger permissible deductions for contributions and greater annual allocations to accounts than are permitted for other defined contribution plans. Generally, an employer may deduct the amount of its contribution to a defined contribution plan up to 15% of the compensation paid to plan participants. If an ESOP borrows to purchase employer securities, the maximum deduction permitted is increased to 25% of participants' compensation, to the extent the compensation is used to repay principal on the loan. Moreover, any contribution used to pay interest on the loan is fully deductible. The maximum amount that may be allocated annually to a participant's account in a defined contribution plan is the lesser of $30,000 and 25% of the participant's compensation. In the case of an ESOP satisfying certain nondiscrimination requirements, the maximum dollar allocation is increased to $60,000.

In addition, other special tax preferences are available for ESOPs and transactions involving ESOPs. First, an employer may deduct dividends paid on employer securities held by an ESOP. Second, banks and certain other financial institutions may exclude from income 50% of the interest received on an ESOP loan. Third, persons who sell employer securities to an ESOP may defer taxation on the gain from the sale if the proceeds of the sale are reinvested in domestic companies and certain other requirements are met. Fourth, an ESOP may assume the estate tax liability of the deceased owner of the employer. Fifth, certain estates may deduct up to 50% of the proceeds from certain sales of employer securities to ESOPs. Sixth, early distributions from ESOPs are exempted from the 10% excise tax on early distributions from qualified plans. Finally, if a reversion from a defined benefit plan is transferred to an ESOP, the reversion is not subject to income tax and the 10% excise tax applicable to reversions. This exception from taxation for reversions does not apply to reversions transferred to ESOPs pursuant to plan terminations occurring after December 31, 1988. Treasury testified before the Subcommittee on Taxation and Debt Management of the Committee on Finance on March 28, 1988 in opposition to any extension of this expiring exemption from taxation for transfers of reversions to ESOPs.

Senate bills S.2078 and S.2291 require a majority of the employees of an employer establishing an ESOP to approve establishment of the plan pursuant to an election conducted by secret ballot. The employer is required to notify its employees of all of the material facts concerning the plan, including (i) the terms of the ESOP, (ii) whether assets from another plan will be transferred to the ESOP and, if so, the terms of the other plan and (iii) whether the ESOP would replace a plan of the employer.

The bills also permit the Secretary of the Treasury to provide that a participant's voting rights required under section 409(e) of the Internal Revenue Code are not satisfied unless the participant's voting rights with respect to securities allocated to the participant's account are substantially similar to the voting rights of holders of the same or similar class of securities.

B. Discussion

The Treasury Department supports the underlying purpose of S.2078 and S.2291, which is to provide ESOP participants with the same stock ownership rights as other holders of similar classes of stock. As I indicated earlier, current law provides significant tax incentives for ESOPs. Although Treasury does not believe this Committee should now reexamine the appropriateness of these incentives, there are questions about whether the existing ESOP rules provide employees with a degree of control consistent with full ownership of their stock.

The bills' requirement of majority approval of employees for the establishment of an ESOP does not directly provide ESOP participants with more substantial stock ownership rights. It is possible that the requirement may have the effect of inducing employers to provide more substantial stock ownership rights so that a majority of the employees will approve the plan. Although we would be sympathetic with this result, it is not clear that employees would exercise their voting rights to secure additional stock ownership rights. Moreover, we are concerned about interfering with the historically voluntary decisions of employers to establish compensation levels or employee benefit plans.

A second more targeted effect of S.2078 and S.2291 is to require ESOPs of closely held corporations to permit participants to vote the shares allocated to their accounts on all matters for which other shareholders of the same class of securities may vote. The bills would have no effect on the voting rights of participants in ESOPs which hold publicly traded employer securities, because equal voting rights are already required in such cases.

Under current tax law, employer securities contributed to an ESOP must be either (i) common stock which is readily tradeable on an established securities market or (ii) where there is no class of stock which is so readily tradeable, common stock which has combined voting power and dividend rights equal to or in excess of the class of common stock having the greatest voting power and the class of common stock having the greatest dividend rights. Additionally, if the securities of the employer are required to be registered with the Securities and Exchange Commission, the ESOP must permit participants to vote the securities allocated to their accounts. If the securities are not required to be registered, participants only have the right to vote in corporate mergers, consolidations, recapitalizations, liquidations and similar transactions.

It is apparent from Senator Armstrong's floor statement given when S.2078 was introduced that the equal voting right provision was intended to override an ESOP trustee's ability to vote shares irrespective of the voting directions it receives from participants. Since this is an issue of fiduciary responsibility governed under Title I of the Employee Retirement Income Security Act of 1974, it is under the jurisdiction of the Department of Labor, which is the proper agency to consider its merits. We understand that the Department of Labor intends to file a written statement for the record on this issue.

INDIAN FISHING RIGHTS INCOME: H.R.2792

A. Background

There is no provision in the Internal Revenue Code that exempts a person from payment of Federal income tax on the grounds that the person is an Indian. Thus, in their "ordinary affairs," Indians are generally subject to Federal income tax to the same extent as other persons. Any exemption from Federal income tax must be derived from treaties or agreements with Indian Tribes, from the Federal tax statutes, or from some other Act of Congress.

Prior to 1871, when the Congress prohibited treaty making with Indian tribes, several Indian tribes entered into treaties with the United States Government and several territorial governments reserving various fishing rights to the Indians. Since then, additional Indian fishing rights have been established by statute, executive order, or agreement later approved by an Act of Congress. Fishing rights secured by various treaties, Acts of Congress, and executive orders have been held to include the right to fish for commercial purposes as well as the right to fish for subsistence purposes. *Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n*, 443 U.S. 658, 676 (1979). In three different cases, the courts have held that income derived by an Indian from the exercise of fishing rights reserved under a treaty was not exempt from Federal income tax, on the grounds that there was no express language in the treaty providing that income from such fishing rights was to be tax-exempt. *Peterson Estate v. Commissioner*, 90 T.C. No. 18 (Feb. 11, 1988); *Earl v. Commissioner*, 78 T.C. 1014 (1982); *Strom v. Commissioner*, 6 T.C. 621 (1946), *aff'd per curiam* 158 F.2d 520 (9th Cir. 1947).

H.R. 2792 would amend the Internal Revenue Code to exempt from tax income derived by a member of an Indian tribe from the exercise of fishing rights of the tribe that are protected by treaty. The exemption would also apply to income derived from the exercise of protected fishing rights by certain Indian-owned corporations and other business entities, referred to by the bill as "qualified Indian entities". Income derived by an individual member of a tribe from the exercise of protected fishing rights would be exempt, whether such income is in the form of earnings from self-employment, wages paid by another member of the tribe, wages paid by a qualified Indian entity, or dividends or other distributions from a qualified Indian entity. Income exempted under the bill from Federal taxation would also be exempted from State taxation.

The bill would exempt income derived from protected fishing rights not only from income taxes, but also from employment taxes, including social security (FICA), and unemployment compensation (FUTA) taxes. The bill would amend the Social Security Act to provide that exempt income is not taken into account in determining social security benefits. The bill would be effective for all taxable years, and thus would resolve all current disputes between the Internal Revenue Service and taxpayers involving prior years, and would apply to requests or actions for refunds that are not time-barred. The bill would also provide the sole basis for exempting fishing rights income from tax; it would prevent treaties and other laws from being construed to provide a tax exemption for such income.

B. Discussion

The Treasury Department recognizes that the issue of taxation of income derived by Indians from exercise of fishing rights protected by treaty is of great concern to Indian tribes throughout the country, and particularly in the Northwest and Great Lakes areas. As previous testimony from the Department of the Interior has indicated, at the time these treaties were signed, many tribes reserved the right to fish in perpetuity. Statement of Ross O. Swimmer, Assistant Secretary for Indian Affairs, Department of the Interior, Hearings of the Select Committee on Indian Affairs, United States Senate, on S. 727, a Bill "To Clarify Indian Treaties and Executive Orders with Respect to Fishing Rights," March 27, 1987. The Indians who were parties to the treaties understood that they would be able to fish (and trade fish) on the same basis as before the treaties, when they were neither required to pay taxes nor turn over any portion of their catch to the Federal Government. H.R.2792 would embody that understanding in law by providing a tax exemption for fishing rights income even though no express exemption is provided by treaty or other authority.

The Administration supports H.R.2792, while also believing that it should not serve as a precedent for conferring tax-free status on all income derived by Indians from resources covered by treaties. Moreover, we understand that fishing serves a number of unique and important functions in Indian cultural and religious life, and thus may be distinguished from other types of activities engaged in by Indians that would remain fully taxable under H.R.2792.

TREATMENT OF CERTAIN SHORT-TERM OBLIGATIONS IN THE HANDS OF CERTAIN TAXPAYERS: S.1239

A. Background

Section 1281 requires certain taxpayers to accrue interest income on short-term obligations (obligations with a fixed maturity of not more than 1 year). Section 1281 applies to, among others, accrual-basis taxpayers, dealers, banks and regulated investment companies. With respect to taxpayers not subject to section 1281, section 1282 requires the deferral of interest expense on leveraged purchases of short-term discount obligations. Both sections are effective for obligations acquired after July 18, 1984.

Section 1803(a)(8)(A) of the 1986 Act added section 1281(a)(2) in order to clarify that the accrual rule of section 1281 applies to both acquisition discount and accrued, but unpaid, coupon interest on short-term obligations. This amendment to section 1281 under the 1986 Act is effective for obligations acquired after September 25, 1985. Section 118(c)(1) of the Technical Corrections Act of 1988 would make the amendment effective for obligations acquired after December 31, 1985.

S.1239 would exempt banks not otherwise using an accrual method of accounting from both sections 1281 and 1282 with respect to loans made in the ordinary course of the banks' trade or business. Accordingly, such banks would not be required to accrue interest with respect to such loans and, also, would not be required to defer interest expense incurred in producing such deferred interest income. The provision would be effective for obligations acquired after July 18, 1984.

Moreover, with respect to taxpayers to whom section 1281 still applied, S.1239 would change the effective date of the provision which requires accrual of coupon interest on short-term obligations under section 1281 to obligations acquired after October 22, 1986.

B. Discussion

The Treasury Department opposes S.1239.

In general, the accrual method of accounting is preferable to the cash method of accounting because the accrual method provides a more accurate method of determining taxable income. Under the accrual method of accounting, items of income are recognized as they are economically incurred, as opposed to when they are paid. Accordingly, it is generally appropriate to use the accrual method except where the additional complexities created by the use of such method outweigh the improvement in income measurement that the method provides.

As part of the 1984 Act, Congress decided that in the case of certain taxpayers, including banks, it was appropriate to require accrual of acquisition discount on short-term obligations. Banks, including small banks, were included under the requirement because they are generally sophisticated taxpayers with respect to both the financial systems which they maintain and the financial instruments in which they regularly deal. Furthermore, banks generally determine their income from short-term obligations on an accrual basis for regulatory accounting purposes. Thus, applying the provisions of section 1281 to banks was not viewed as imposing unreasonable administrative burdens on the affected taxpayers.

Moreover, in addition to the general superiority of accrual tax accounting, there are other strong policy reasons for continuing to apply section 1281 to small banks. An exception for small banks would effectively permit small banks to use the interest expense incurred in carrying such obligations to shelter other unrelated income, leading to a distortion of income and a mismatching of income and expense.

With respect to the provision in the 1986 Act clarifying that taxpayers affected by section 1281 must accrue coupon interest, the Treasury Department has no objection to the provision in the Technical Corrections Bill which would change the effective date of the clarification from September 25, 1985 to December 31, 1985. Such a change would have the effect of simplifying the application of the provision for many taxpayers who report income on a calendar-year basis. Changing the effective date to October 22, 1986, however, would provide an unwarranted benefit to the affected banks and would unfairly reward the taxpayers who have failed to comply with the law.

DISCLOSURE OF TAX INFORMATION TO THE VETERANS ADMINISTRATION: S.2611

A. Background

Under section 6103 of the Code, the IRS is required to disclose tax return information upon request to a variety of agencies or individuals, including federal and state tax administrators, certain other government agencies, and certain interested persons such as a taxpayer's spouse or attorney. The IRS is not currently required to disclose tax return information to the Veterans Administration. The bill would require the IRS to disclose tax return information to assist the VA in its administration of its benefit programs.

B. Discussion

The Office of Management and Budget has advised that the Administration's position on this bill is under development. Consequently, my testimony today represents solely the Treasury Department's views on this issue.

Although the Treasury Department is sympathetic to the needs of the VA for information, it opposes this bill on the ground that it is the type of *ad hoc* modification to section 6103 which tends to undermine the confidentiality of tax returns and has the potential to damage the voluntary compliance system. In this respect, S.2611 resembles other similar modifications, which have been made or proposed.

Section 6103 was completely revised in 1976. The revision was due in large part to concerns regarding the unwarranted disclosure and inappropriate use of tax returns, in some cases for political purposes. The general rule adopted at that time and contained in section 6103 is that tax returns are confidential and are not subject to disclosure except in particular circumstances specified by statute. During the 1980's there has been a steady expansion in the exceptions to the general rule of confidentiality. The largest expansion came in 1984, when Congress required the IRS to commence disclosure of return information to federal, state, or local agencies administering certain benefit programs (AFDC, Medicare etc.). Currently, 55 separate agencies participate in this program. In 1986-87, the IRS made 27.2 million disclosures to these agencies.

GAO has estimated that returns or return information of 80 million taxpayers now are subject to disclosure under section 6103. The bill under consideration would increase the number of taxpayers whose returns are subject to disclosure by 1.6 million.

It is argued that permitting the VA access to tax returns would increase federal receipts. It is possible that receipts may, in fact, be increased, at least in the short term, but we believe that focusing on increased receipts in this context is a shortsighted approach.

Allowing the Veterans Adminstration access to taxpayer return information will encourage other agencies to seek similar access. Typically, as in the current case, a federal agency seeking access to tax returns would be able to present data showing that federal receipts would be enhanced. In each case, the argument would also be made that it would not result in a significant increase in the number of taxpayers subject to disclosure. Thus, in any particular case an agency will be able to make the same arguments that are made today. If we grant the VA access to tax records, it will be difficult to deny access to other agencies in the future. The eventual result will be that confidentiality of tax returns will have become a hollow promise.

We believe that taxpayers have a right to expect that their tax returns will remain confidential. Furthermore, it is possible that permitting increased access to tax returns may actually result in a reduction in voluntary compliance. Any reduction in voluntary compliance would lose far more in federal revenue that would be gained by permitting agency access to tax records. (The IRS has estimated that a 1% drop in voluntary compliance would cause federal revenues to drop by $3.8 billion.) Admittedly, at this time we do not know for certain that weakening confidentiality will reduce compliance. The IRS has begun a study of this issue, and we believe that any further expansion of the exceptions to return confidentiality, even where an increase in federal receipts can be predicated, should await the outcome of the study. Furthermore, we believe that amendment of section 6103 should not be handled on a piecemeal basis in response to requests from specific agencies. Certainly any federal agency would prefer to have the power to order the IRS to disclose tax information, especially if other agencies are being granted that power. Because of the important principles involved, amendment of section 6103 should be handled on a comprehensive basis; if there are good reasons to allow the Veterans Administration access to return information, then it should be handled as part of a general rule allowing federal agencies access in certain cases.

In summary, we believe that Congress should not amend section 6103 to permit additional disclosure of tax return information until the completion of the study on confidentiality and taxpayer compliance. If, after the study is completed, amendment of section 6103 appears in order, then section 6103 should be revised by means of a thoughtful, comprehensive approach.

EXCLUSION FOR CERTAIN SEAFOOD PROCESSORS FROM THE DEFINITION OF EMPLOYEE: S.1821

A. Background

An employer is required to withhold from its employees' wages Federal income tax and the employee's share of Federal Insurance Contributions Act (FICA) tax and to pay Federal Unemployment Tax Act (FUTA) tax and its portion of the FICA tax. These taxes only apply with respect to employees. S.1821 excludes certain seafood processors from the definition of "employee" and, thus, such seafood processors would be treated as self-employed individuals.

B. Discussion

The Treasury Department opposes S.1821 because it treats seafood processors who are in fact employees as self-employed individuals for Federal tax purposes. This treatment is both unfair and burdensome to seafood processors and detrimental to the Federal tax system. If seafood processors are treated as self-employed individuals, they would be required to pay taxes under the Self-Employment Tax Act (SECA) in an amount approximately equal to the sum of the employer's and employee's portions of the FICA tax. The employers of the seafood processors would pay no FICA or SECA taxes for these employees. Seafood processors who are not operating their own businesses and who are unaccustomed to keeping business records would be required to file additional tax forms and remit therewith Federal income and SECA taxes. Such a system of collecting taxes is not as effective as the withholding system and, thus, S.1821 has the effect of losing revenue.

CONCLUSION

This concludes my prepared remarks. I would be pleased to address any questions which you might have.

CHARLES SEAMAN

Mr. Chairman and members of the Subcommittee, my name is Charles Seaman. I am President of the First State Bank of Warner in Warner, South Dakota. I am here to testify in strong support of S.1239, which would repeal the requirement that small cash basis banks accrue interest on short term loans. Thank you very much for allowing me to testify today. I would like to note that my statement is supported by the American Bankers Association and commercial banks across the country.

History

Internal Revenue Code Section 1281, which requires the accrual of interest on short term obligations, including short term loans, is an extension of a series of provisions enacted in the past several years aimed primarily at the taxation of original issue discount and acquisition discount on bonds and similar instruments.

Initially, certain short term obligations were excepted from the original issue discount rules, but in the Tax Reform Act of 1984, Congress added Section 1281 to the Code, which extended the coverage of the discount rules to short term obligations. Nothing in the conference reports and explanation of that bill indicated that the discount rules were intended to apply to stated interest income from short term loans.

Then, in the Tax Reform Act of 1986, Congress included a a technical correction to Section 1281 of the Code, expressly stating that interest income on short term obligations, including short term loans, must be accrued. The rule was applied regardless of whether the taxpayer was on the cash or accrual method of accounting. Furthermore, it was said to apply "whether the interest is stated or is in the form of acquisition discount or original issue discount, and irrespective of when any stated interest is paid."

The Tax Reform Act of 1986 was enacted in October 1986, but the Section 1281 provision was made effective for obligations acquired after September 27, 1985.

Conflict with Section 448(c)

Congress also enacted in the Tax Reform Act of 1986 a provision limiting the cash basis of accounting to businesses with average annual gross receipts of $5 million or less. That provision is now contained in Internal Revenue Code Section 448(c).

Nowhere in Section 448(c) is it stated that banks may not avail themselves of the exception for small businesses, and the IRS has not disputed the fact that small banks fitting the definition in Section 448(c) may do so.

By forcing small cash basis banks to accrue interest on short term obligations, Section 1281 is in direct contradiction to Section 448(c) enacted in the same statute.

Reflection of Farm Economy in Loan Terms

Farm income is seasonal. Periods of expenditures for planting crops or initiating livestock operations alternate with periods of income from the sale of the crops or livestock that are produced. Farmers take out loans to meet the expenses, and repay those loans, both principle and interest, when they receive their income. As a practical matter, farmers do not have regular income on a weekly, monthly or quarterly basis. Rural banks, therefore, do not establish regular payments for loans to farmers.

Operating loans are almost always short term, that is, less than one year from the date of the loan until maturity. They may be extended and mature within the bank tax year, or they may be extended in one year and mature in the next, depending upon the local growing seasons and the specific purposes for which the loans were taken out. Maturity dates on these loans are not set arbitrarily. Prudence requires that the loans be set to mature when the borrower will have the proceeds of the harvest or livestock operation available to repay the loan.

I should point out that my bank, like most community banks, does not deliberately incur extra borrowing expense to fund these loans. Our source of funds consists of local deposits. The seasonal nature of the farming economy also prevents farmers from being able to commit their deposits for long periods of time.

Matching the interest rate sensitivity of both assets and liabilities is a fundamental policy of managing interest rate risk for a bank. If a bank has short term deposits that will quickly reflect increases in interest rates, then loans must also be short term so that interest income will keep pace with increases in interest expense.

Financial Impact of Section 1281 on Small Banks

Section 1281 requires banks to recognize substantial amounts of income before that income is actually received. Where loans span two tax years, the bank must include a pro rata portion of the future interest income in the first year, and pay tax on that income.

The issuance of short term loans constitutes the majority of a small rural bank's business. These banks generally do not do business outside of their communities; therefore, they do not have the capability of diversifying their portfolios as larger banks have, particularly those in urban areas. Thus, the cumulative effect of Section 1281 is extremely onerous and creates severe cash flow problems for a small bank stretching to meet the added tax liability.

For many small banks, the effect of Section 1281 is more burdensome than switching to the accrual method. It requires small banks to accrue income on short term loans, but limits recognition of the offsetting interest deduction until it is actually paid. The bottom line is that some banks face nearly triple the tax liability that they would have paid under the full accrual method.

Administrative Impact of Section 1281

Section 1281 imposes significant administrative problems on small banks. Small cash basis banks do not keep records of short term loans per se. This category does not conform to any grouping which banks use for financial reporting purposes, regulatory reports, management decisions or other tax reporting. Financial and regulatory reports categorize loans by type of borrower or collateral (agricultural loans, commercial loans, consumer loans, auto loans, etc.). For purposes of interest rate risk management, it is crucial that banks sort loans according to the next date at which the interest rate can be adjusted or by the maturity date.

Lack of Transition Relief for Section 1281

Despite the substantial impact of Section 1281, no transition rule was provided to banks affected by the new provision. Normally, Congress has sought to make changes in the law fair by permitting taxpayers who are affected to spread the impact or by allowing a period of preparation for the new rule during which appropriate adjustments may be made.

Not only was there no transition relief granted in Section 1281, the provision was retroactive in its effect. The current technical corrections legislation, if enacted, would improve the retroactivity problem slightly, in that banks would not have to refile their 1985 returns. Banks still would not have had an opportunity, however, to switch to full accrual. This is because the IRS requires applications for changing a taxpayer's tax year to be submitted during the first 180 days of the taxable year in which the taxpayer wishes to switch.

S.1239

The bill introduced by Senators Daschle, Armstrong, and Durenberger would make the treatment of banks consistent with the policy of Section 448(c), which allows small businesses to use the cash method of accounting. I strongly urge the Finance Committee to adopt the provisions of S.1239 in the upcoming technical corrections legislation.

If that is not possible, I hope that members of this Committee will at the very least consider enacting some sort of transitional relief to help small banks adjust to the severe impact of Section 1281.

Again, thank you Mr. Chairman and members of the Subcommittee for permitting me to be here to discuss this matter that is so important to small banks.

TESTIMONY OF
HONORABLE FRANK S. SWAIN
CHIEF COUNSEL FOR ADVOCACY
U.S. SMALL BUSINESS ADMINISTRATION
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE
OF THE U.S SENATE
ON MISCELLANEOUS TAX BILLS

July 12, 1988

Mr. Chairman and Members of the Subcommittee on Taxation and Debt Management:

As Chief Counsel for Advocacy, U.S. Small Business Administration, I am pleased to appear before you to express my views on S. 2484, a proposal to extend and improve the Research and Experimentation (R & E) Tax Credit. My views here today reflect those of the SBA and the Administration.

It is appropriate that small business is represented here today. Research studies funded by the Office of Advocacy have shown small firms to be prodigious innovators; innovating at a rate twice that of large firms per employee,[1] spending twice the percentage of their research budget on basic, as opposed to applied research,[2] and creating more than 20 times the innovations for the same amount of R & E tax credit claimed.[3] Despite this, the design of our current credit structure has prevented small business from fully utilizing the credit or receiving an equitable share of its benefits. Moreover, the credit has been completely denied to start-up firms in their efforts to develop innovative products vital to America's continued competitiveness. I strongly support the enactment of a permanent R & E Tax Credit to replace the current credit which is scheduled to expire December 31, 1988. I believe, however, that the credit must be restructured to achieve its essential purpose.

The legislation under consideration by this Subcommittee would introduce much needed changes to the credit structure, substantially improving its effectiveness. It is the product of considerable effort to address concerns over widely recognized structural problems on behalf of Congress, the business community, both large and small, and government representatives from the Small Business Administration, the Department of Commerce, the Department of Treasury and the National Science Foundation.

The current R & E tax credit, codified in section 41 of the Internal Revenue Code (I.R.C.), applies to the increase of the present year's qualified R & E expenses over a "base," which is generally the average annual amount of qualified R & E expenditures over the three years preceding the year in which the credit is being claimed. As an important limitation, I.R.C. § 41(b)(1) restricts creditable expenditures to those incurred "in carrying on" an existing trade or business.[4]

Under S. 2484, for the first time the credit would be available to new firms or firms expanding into new trades or businesses which intend to use the research in the active conduct of a "future trade or business," effectively removing the "in carrying on" restriction. Because of the "in carrying on" restriction, the R & E expenses leading to many of America's most significant small business innovations would not have been eligible for the credit. This includes the R & E leading to the development of magnetic resonance imaging, the six-axis robot arm, the airplane, the helicopter, the human growth hormone, the Polaroid camera, the programmable computer, the super computer, and the personal computer. By allowing the credit to be taken by firms who have not yet brought their products to market, the legislation will remove this long-standing problem and further encourage small firm innovation.

Equally important, the legislation would eliminate features that have prevented established businesses from fully utilizing the credit. Because the credit is tied to previous years' R & E expenditures, expenditures by a firm in one year serve to block availability of the credit in future years. In order to maximize the credit, some firms have been artificially stimulated to postpone or otherwise adjust their R & E spending downward. This problem, acute in small firms, would be obviated by S. 2484, which would replace the "moving-base" with a "fixed-base," smoothly phased in for new companies. A "fixed-base" credit, unaffected by a firm's current year R & E expenditures, would provide a constant, predictable incentive to perform R & E. Incentives for increasing R & E intended by current law would be preserved under S. 2484, while existing disincentives would be ameliorated. Finally, a secondary feature of the credit would widen availability of the credit by enabling firms which do not happen to be in high growth industries, but which still perform significant R & E, to take a reduced credit.

The restructured credit proposed in S. 2484 would provide an effective incentive for R & E, which has been long overdue. I urge the Senate to adopt S. 2484 as part of the Technical Corrections Act currently under consideration.

I. Small Business Need for the R & E Credit

Small firms may be reluctant to direct money to R & E because of the difficulty they experience in recapturing profit from their efforts. With less market identity and smaller distribution networks, they may lack the ability to rapidly penetrate markets, particularly when products or processes do not enjoy intellectual property protection. Even when the potential societal benefits of an innovation exceed the costs of research and development, small firms may not be able to translate enough of those benefits into their own profit to afford R & E investment. In many cases, small firms generate ideas, only to see the final product manufactured and sold by other firms, domestic and foreign. A well designed credit would serve to close the gap between the benefit enjoyed by society from an innovation and the economic benefit recovered by the innovating firm.

In addition, a new R & E tax credit is needed to offset the costs of financing research in order to decrease the risk to potential investors in small firms. Small firms, when performing research, must often rely on expensive, private sources of financing since they have less access to traditional debt and equity markets than large firms. This reliance on external financing often presents small firms, particularly those dependent on a single, cherished innovation with a unique problem: whether or not to expose their innovations to potential investors. Moreover, potential investors may be dissuaded from investing in R & E-intensive small firms because of the inherent financial risks of R & E projects. A credit will assist firms in securing financing by increasing the after-tax profits earnable by investors.

Finally, a new R & E credit is necessary to give all American business the same level of incentive to perform private sector R & E as is currently provided by other developed countries. Japan, for example, targets a substantial flat credit for R & E expenditures to small and medium-sized businesses. Under Japanese law, a taxpayer with fewer than 1,000 employees, in lieu of a 20 percent incremental tax credit, may elect a flat tax credit equal to 6 percent of qualified R & E expenses or 15 percent of the income tax on business income before the credit, whichever is smaller. Also, Japan accords a 7 percent credit on the acquisition or manufacturing cost of high-technology machinery.[5] If America is to maintain her technological lead, we must have a strong commitment to private sector R & E.

II. Small Business Problems with the Current R & E Tax Credit

A. The Current Credit is Inequitably Distributed

The Federal subsidy accruing from the R & E tax credit is not available to small firms to the same extent as large firms, even though small firms are more innovative per employee than large firms. Chart 7 of Attachment 1, which shows the approximate tax credit cost per innovation as a function of firm size, indicates that small firms produce more than 20 times the innovations per dollar of tax credit claimed than do large firms. In particular, small firms produce 155 innovations per million dollars of tax credit claimed, while large firms produce 6.5 innovations per million dollars of tax credit claimed. Thus, large firms receive over $150,000 in Federal tax subsidy for every innovation they introduce while small firms receive less than $7,000.[6]

The Corporate Statistics of Income (SOI) data for 1983 indicate that the use of the R & E credit increases exponentially with the size of a firm. For example, in 1983 an average firm with 168 employees claimed $6.32 in credits for every $100,000 in business receipts, while a firm of 1,319 employees claimed, on the average, $18.95 in credits for every $100,000 in business receipts (See Chart 1 of Attachment 1). Chart 5 shows a similar pattern in the research-intensive manufacturing sector (see Charts 3 and 5 of Attachment 1), which is estimated by the GAO to utilize 83.3 percent of the current R & E tax credit. According to the GAO, 77.6 percent of the R & E credit goes to businesses with over $250 million in assets.[8]

SBA has analyzed the effect of S. 2484 on hypothetical firms with different R & E spending patterns in Attachment 2. In general, firms, large and small, new or established, would greatly improve their position with S. 2484 over current law. Start up firms would benefit because of the smooth phase-in "base" calculation for these firms. Those firms not benefiting, cyclical spending firms, would be discouraged from purposefully increasing and decreasing their expenditures in order to maximize the credit. I would refer you to Attachment 2 for a more complete analysis of the impacts of S.2484 on hypothetical firms.

B. The Current Credit is Denied to Start-up Firms

One of the principal problems with the current credit is that it is misdirected; disqualifying expenditures by new firms and firms branching into new trades or businesses while rewarding incremental improvements in existing technologies or product lines. The "in carrying on" limitation was originally enacted to prevent taxpayers from investing in abusive R & E tax shelters at a time when passive losses and credits could offset active income. Because of changes in the passive loss rules, the restriction is no longer needed as a safeguard, but the negative effect remains for new research-oriented firms which often incur substantial R & E costs over many years before their product is marketable. I believe this restriction is one significant factor contributing to the less frequent use of the R & E credit by small firms relative to large firms.

C. The Current Credit Structure Interferes with Market Strategy

The current credit system also tends to interfere with, rather than augment, sound market decisions. The "moving base" structure of the current credit, which dictates how much credit a firm can take, is intended to stimulate continued annual increases in R & E spending by applying the credit rate to the difference between current year

R & E and spending and the average spending level for immediately preceding years. The structure is designed, however, to enable a firm to influence the amount of future credit by adjusting its R & E spending, elevating tax strategy over market strategy.

Under the current credit, if expenditures for R & E are made that equal or fall below the average "base", the tax credit for those expenses will be permanently lost. Likewise, when growth rates accelerate or fluctuate, as is the case for many start-up companies, the ceiling as contained in I.R.C. § 41(c)(3) may be exceeded.[9] R & E expenses that are not creditable will be added to the "base" to reduce or eliminate the credit in later years. A firm will, therefore, gain no tax advantage from expending money for R & E in an amount which falls below the "base" or exceeds the ceiling, even though these expenses may be increases over the preceding year. Sound tax planning would instead encourage a firm to forgo research to reduce the spending "base" or avoid the ceiling amount. Larger firms are also encouraged to redirect research funds among their trades or businesses in order to maximize the firms overall tax benefit.

Since the value of the credit can be optimized by steadily increasing expenditures, firms that can assume a more steady R & E growth posture, are favored over firms that cannot. Firms that cannot steadily increase their expenditure level, typically smaller firms, are encouraged to purposefully cycle their R & E expenditures to maximize the credit.

Furthermore, by tying a firm's credit to preceding years' spending levels the structure ensures the disproportionate distribution of the subsidy to firms which happen to be in high-growth fields relative to firms in emerging or slow-growth fields. Since high growth industries tend to naturally increase research expenditures as sales increase, the credit's incentive effect is reduced.

III. Conclusion and Recommendations

An R & E tax credit is a vital incentive for performing innovative research by small and large firms, yet, as currently constituted, it is inefficiently and ineffectively designed. It should also be noted that, since firms cannot increase their research expenditures indefinitely, the current incremental tax credit system is inconsistent with a permanent tax credit. Ensuring the proper distribution of the credit among firm sizes and industries, reducing disincentives to invest in R & E, especially for small firms, and making the credit more efficient should be major goals of any restructuring of the R & E credit. Extending the credit for limited duration, without reaching these goals, would only continue poor tax policy and preserve the climate of uncertainty which has existed since the credit's inception.

I urge the Subcommittee to adopt S. 2484 or legislation that accomplishes its essential purpose. The reforms contained in S. 2484 will eliminate negative incentives for performing R & E by severing the connection between the amount of credit available to a firm and its immediate past R & E expenditures. S. 2484 would also ensure that the credit stimulates new product and technological development by effectively eliminating the "in carrying on" limitation. Finally, the new structure would greatly widen the credit's availability among slower growth firms through the secondary credit calculation.

Reform of the credit and its permanent extension will assist all firms in developing the products and processes which are vital to America's international competitiveness. Making the credit more available to small businesses will return the greatest number of innovations per dollar of tax subsidy.

Footnotes

1. Sources: Gellman Research Associates, The Relationship Between Industrial Concentration, Firm Size and Technological Innovation (Washington, D.C., U.S. Small Business Administration, Office of Advocacy, May 1982, NTIS #PB82226119); The Futures Group, Characterization in Innovation Introduced on the U.S. Market in 1982 (Washington, D.C.: U.S. Small Business Administration, Office of Advocacy, March 1984, NTIS #PB84 212067); and, Gellman Research Associates, Indicators of International Trends in Technological Innovation (Washington, D.C.: U.S. National Science Foundation, April 1986). According to the Gellman study, small firms create 2.45 times as many innovations per employee than do large firms. The Futures Group supported this conclusion at a rate of 2.38, finding that on a per employee basis small firms are 1.91 times as likely as large businesses to make first-of-type innovations, and 2.46 times as likely to make modest improvements in existing technology.

2. U.S. National Science Foundation, Trends to 1982 in Industrial Support of Basic Research (Washington, D.C.: U.S. Government Printing Office; 1982, NSF 83-302), Table B-2.

3. See Chart 7, Attachment 1. This statistic was derived from combining data from three sources: (1) the IRS/SBA Match File (1979), which links size of firm by asset category to average firm employment; (2) the IRS 1983 Statistics of Income; (3) and the Futures Group Study (id. at note 1).

4. A distinction between IRC § 41 and § 174, which permits expensing in connection with a trade or business, was explored in Snow v. Commissioner, 416 U.S. 500 (1974).

5. YOJI GOMI, Guide to Japanese Taxes, 1986-87, Tokyo; Zaikei Shoho Sha (Published in 1986) p. 126.

6. Id. at note 3.

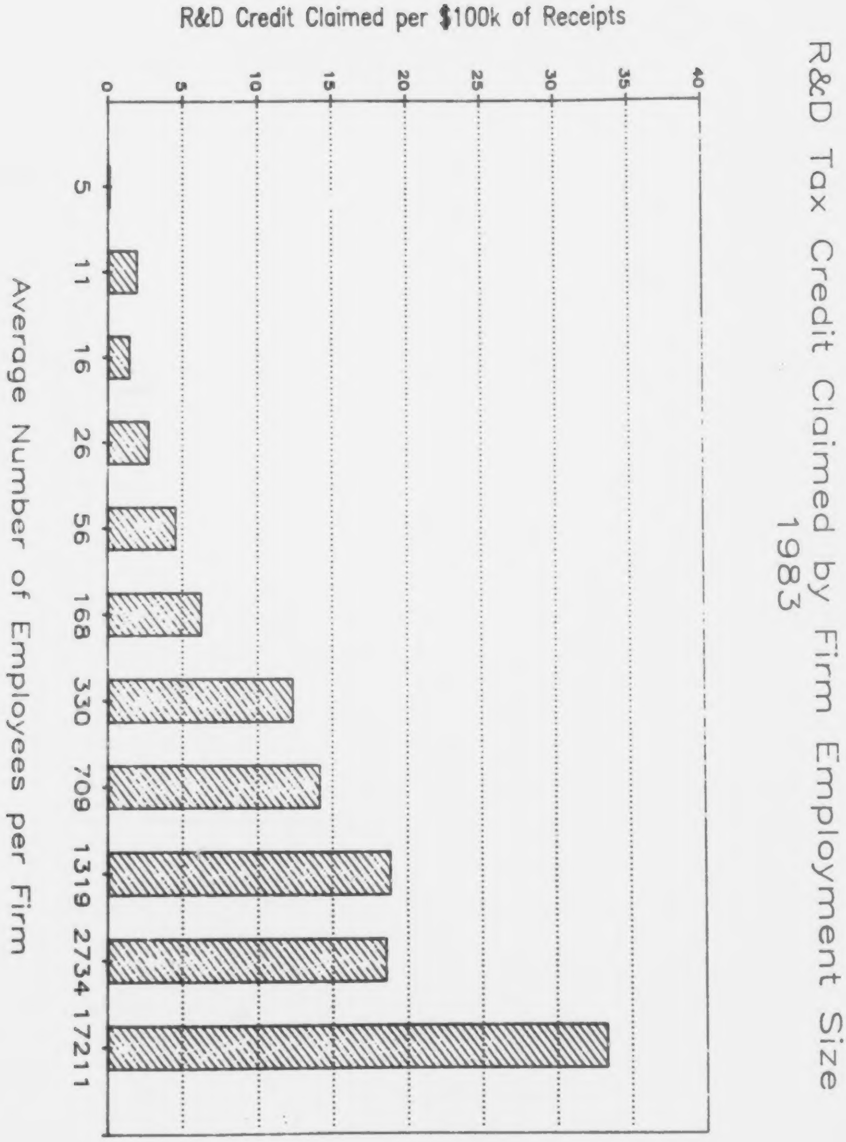
7. Briefing Report to the Honorable Brian Donnelly, U.S. House of Representatives, Preliminary Analysis of the Research and Experimentation Tax Credit, Government Accounting Office, June 1988 (GAO/GGD-88-98BR) and accompanying letter dated June 17, 1988. The statistic tracks data from 1981 to 1984.

8. Ibid.

9. This limitation statutorily restricts annual qualified expenditures to the lesser of 50 percent of the current year R & E expenditures or the increase in those expenditures over the three previous years. In practice, the limitation applies when R & E expenses annually increase at an effective rate of about 45 percent. See Attachment 3 for a more detailed explanation.

ATTACHMENT 1

Chart #1



R&D Tax Credit Claimed by Firm Employment Size
1983

Chart #2

R&D Tax Credit Claimed by Firm Employment Size
1984

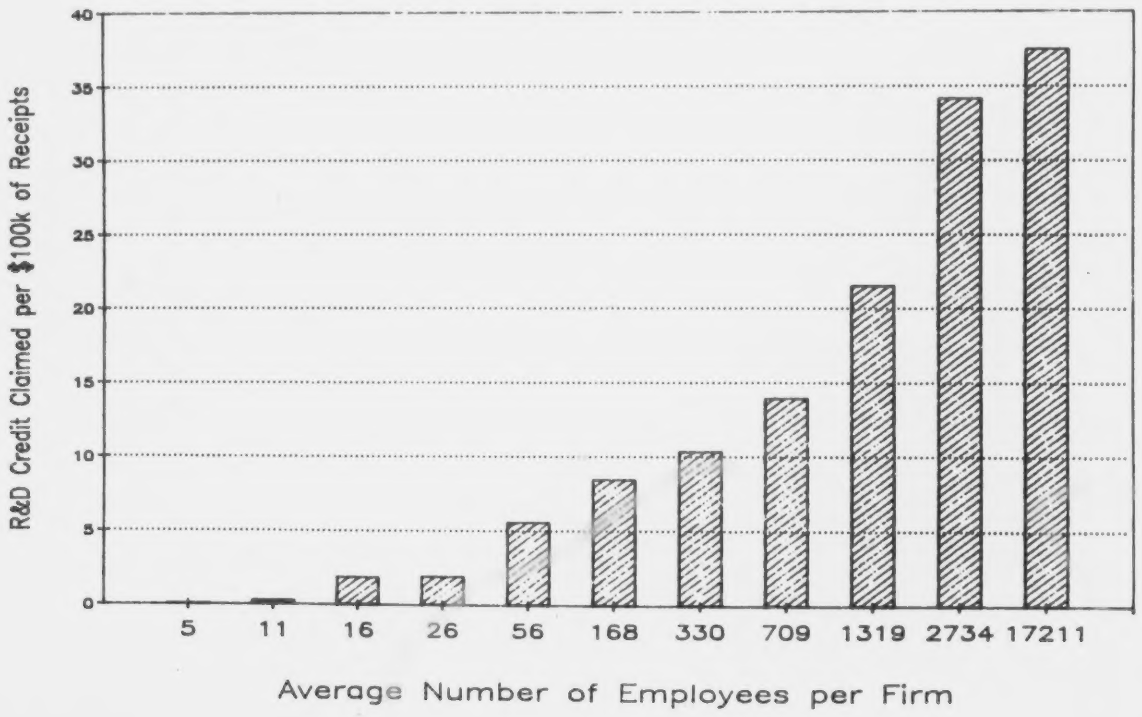


Chart #3

R&D Tax Credit Claimed by Firm Employment Size
1983

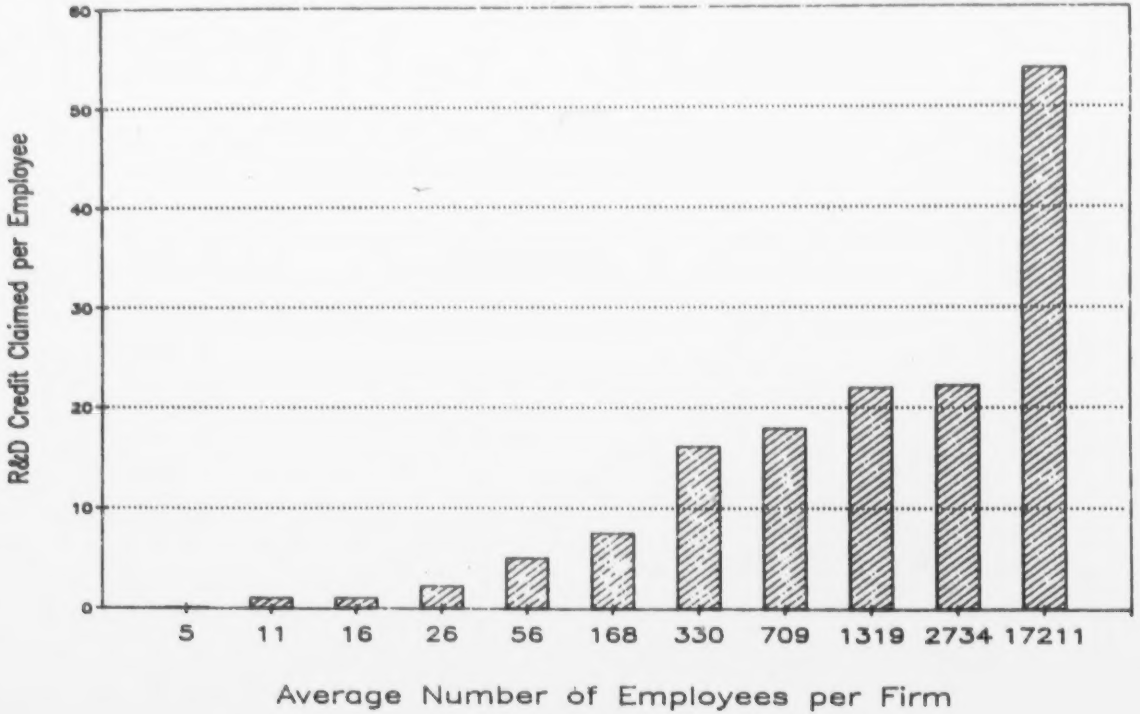


Chart #4

R&D Tax Credit Claimed by Firm Employment Size
1984

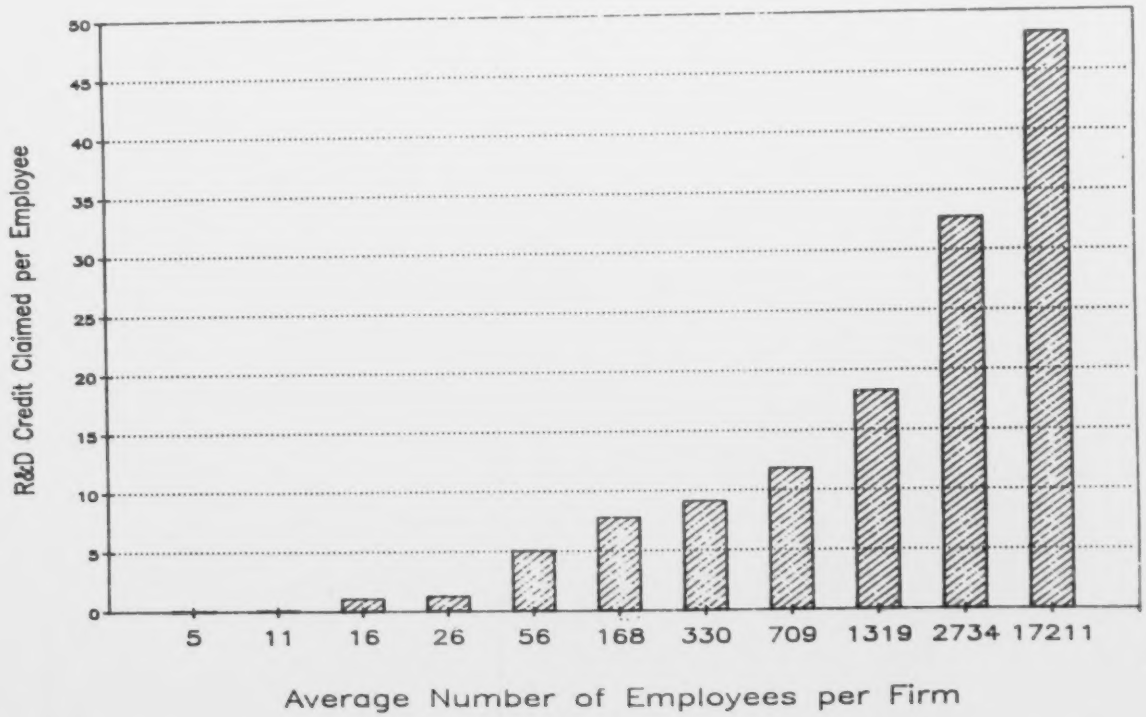


Chart #5

R&D Tax Credit Claimed by Firm Employment Size in Manufacturing (SIC Codes 20–39), 1984

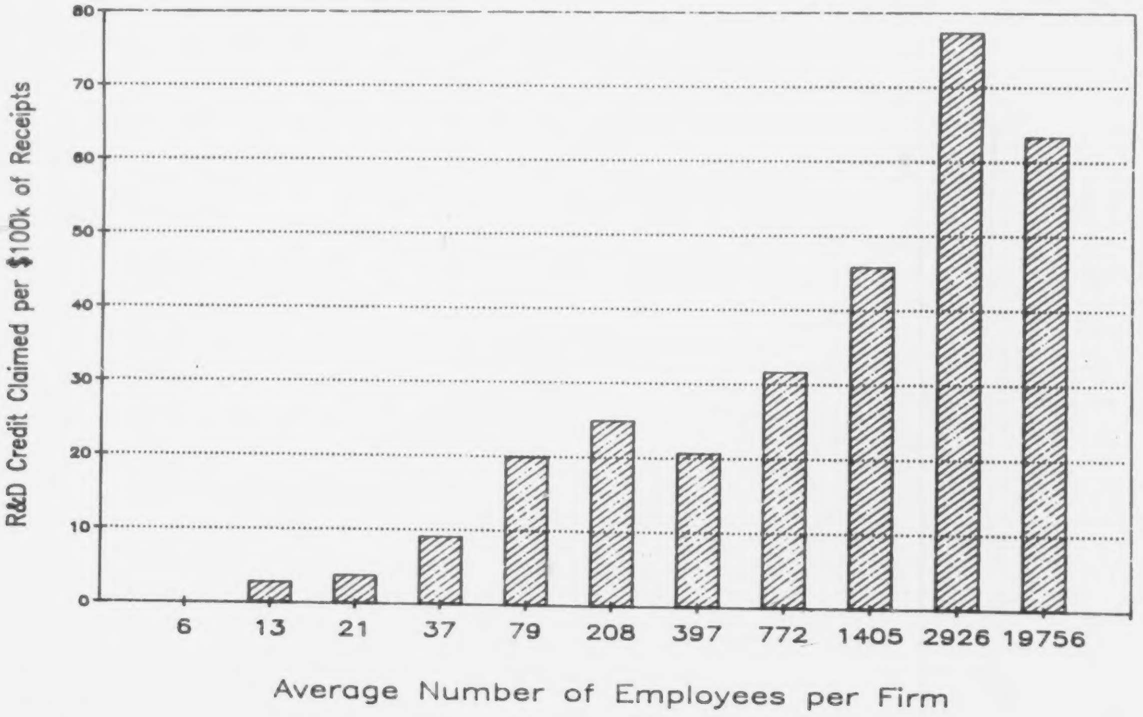


Chart #6

R&D Tax Credit Claimed by Firm Employment Size
In Manufacturing (SIC Codes 20--39), 1983

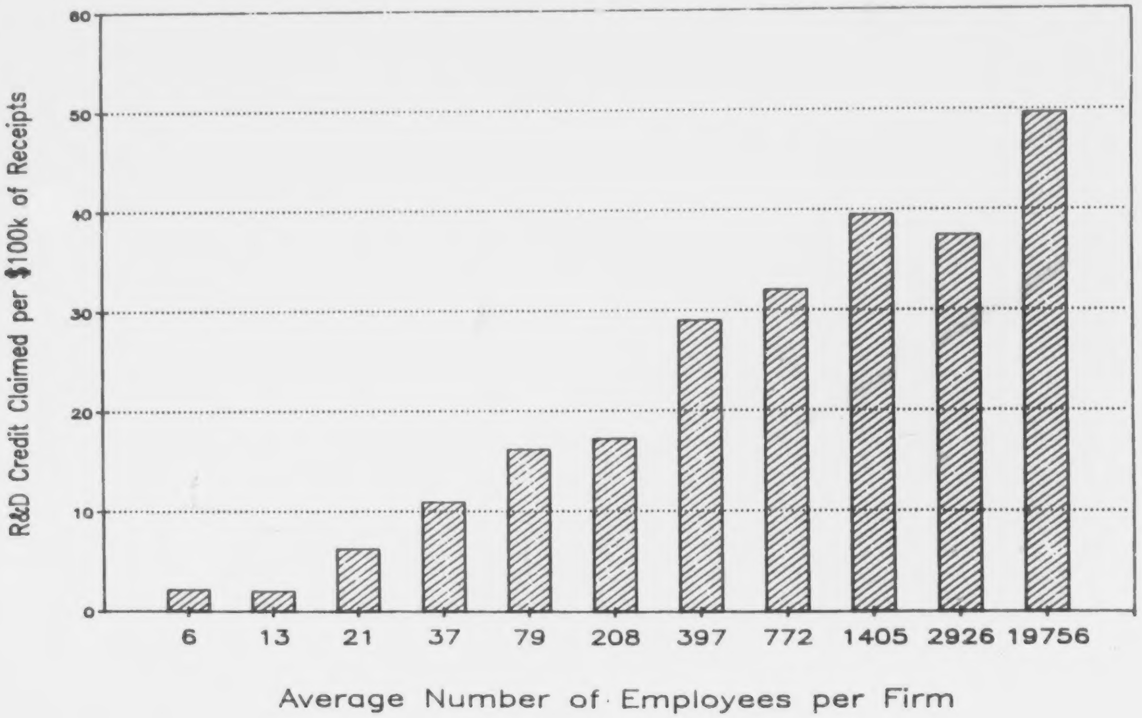
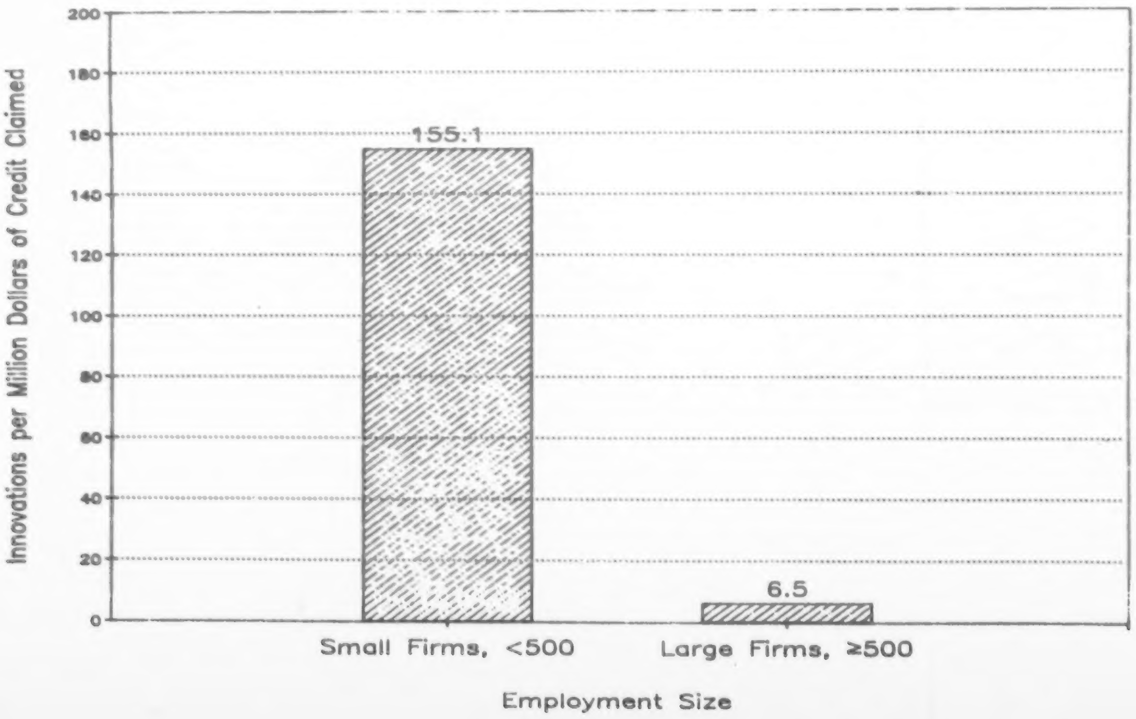


Chart #7

Innovations per Million Dollars R&D Tax Credit Claimed In 1983



Notes on Attached Charts

The Statistics of Income (SOI) data of the Internal Revenue Service (IRS) are devoid of employment data. The published SOI data are arrayed by firm asset size class.

However, the 1979 IRS/SBA MATCH file contains SOI data augmented with employment data (as recorded on the Employers' Federal Quarterly Tax Return). These data allow the calculation of the average firm employment size (i.e., average number of employees per firm) by firm asset size class and industry.

The crosswalk between asset size and employment size that is facilitated by the MATCH file was used to estimate the number of employees associated with the returns represented in an SOI asset size cell.

The firm employment size classes that are arrayed along the horizontal axes of the attached charts are simply the average number of employees per firm within each of the SOI asset size classes.

Charts 1 and 2. R&D Tax Credit Claimed Per Dollar of Receipts by Firm Employment Size in 1983 and 1984

For each asset size class and year, the total research activities credit claimed was divided by business receipts (in $100,000 units). The result is the R&D credit claimed relative to revenues. This ratio was then plotted as a function of firm employment size. Charts 1 and 2 clearly show that the R&D credit claim per dollar of revenue falls as the average firm employment size falls.

Charts 3 and 4. R&D Tax Credit Claimed per Employee by Firm Employment Size in 1983 and 1984

The total research activities credit for each asset size class was divided by the number of employees estimated to be represented by that asset size class. (In particular, the average number of employees per return within an asset size class was multiplied by the number of returns represented by that size class.) Charts 3 and 4 show that the R&D tax credit claimed rises with firm employment size, even on a per employee basis.

Charts 5 and 6. R&D Tax Credit Claimed Per Dollar of Receipts by Firm Employment Size in 1983 and 1984: Manufacturing

The data displayed in this chart were derived in a manner analogous to those displayed in Charts 1 and 2, except that the tax credit data and asset-employee relationships pertain expressly to manufacturing.

Chart 7. Innovations per R&D Tax Credit Claimed: Small Firms vs. Large Firms

Using 1983 SOI data and the 1979 IRS/SBA Match file the employment by asset category for the first 7 categories (up to 25 million in assets) were summed to get the total employment of small firms. The employment associated with the 4 largest asset size classes was aggregated to get the total employment of large firms.

The R&D tax credits claimed were aggregated into small and large firm categories in a manner analogous to the employment aggregation, described above.

The results of the 1982 Futures Group study (published in 1984) of innovations by firm size, which found that small firms produce an estimated 745 innovations per million employees and that large firms produce 313 innovations per million employees, were used to derive estimates of the number of innovations produced by small firms (17,582) and by large firms (7,919). These numbers were then divided by the total R&D tax credit claimed by small and large firms, respectively, to obtain the number of innovations per dollar of R&D tax credit claimed for small vs. large firms.

Results:

Small Firms	Large Firms
155.1 innovations per million dollars in R&D tax credit claimed.	6.5 innovations per million dollars in R&D tax credit claimed.

A Note on Possible Future Tabulations

The 1982 MATCH file has recently been developed which means that the data arrayed in these charts could be recalculated using the more current 1982 MATCH file asset-per-employee ratios.

Since there was substantial inflation between 1979 and 1982, the average firm employment size within firm asset size classes probably shrank between 1979 and 1982. This possibility should not, however, seriously impair the credibility of the data presented here.

ATTACHMENT 2

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

Analysis of S.2484 "Research and Experimental Credit Extension and Reform Act of 1988"

The attached Tables 1 through 8 model the effect on hypothetical firms of the current Research and Experimentation Tax Credit (I.R.C. §41) and a proposal to modify the credit, S. 2484. Specifically, current law and the proposal are modeled over a five year period, between 1989 and 1993, to determine its effect on two factors: the calculation of the tax credit and the "historical base", from which tax credit is calculated. The hypothetical firms are divided into four general categories of spending patterns: growing, declining, cyclical, and constant. Tables 9 through 16 model the same spending patterns for the same years, but indicate the effects of the current law on new and start-up firms. All firms were assumed to have R & E expenditures of $200,000 in 1988.

Start-up firms are treated separately under the models because under current law they are not eligible to use the credit. Therefore, tables 9 through 16 are essentially a comparison of S.2484 to two other current proposals, S.2312 and HR. 4795 which would allow start-ups to take the credit, but not otherwise change the current structure of the credit. Tables 9-16 also assume that each start-up firm came into existence in 1984. For some of these firms, negative R & E growth is assumed to occur.

Summary of Analysis

According to the analysis, established firms show substantial increases in credit received in every R & E spending scenario except "cyclical". Fast growth firms (12% annual R & E increases) almost doubled their credit, increasing it from $57,390 to $103,110 for 1989 - 1993. At the other extreme, highly cyclical spending firms decrease their credit from $34,670 to $23,120, while mildly cyclical firms' credit decreased from $9,670 to $7,190. Therefore, in our hypothetical spending scenarios, S. 2484 would provide a disincentive for firms to cycle their R & E spending. At the same time it would encourage increased R & E spending by allowing greater credit rewards.

Under S. 2484 all start-up firms receive more tax credit than under current law. The analysis somewhat understates this result in tables 10 through 16 because it assumes that start-up firms came into existence in 1984. However, firms which came into existence in 1988 or later years would receive a 10% credit for the first three years (due to their zero base for these years) on all qualified expenditures. Because such firms do not have a historic base, they would not be required to calculate the credit with reference to the increase of their current R & E expenditures over their historical base as was done in the analysis. Therefore, in tables 10 through 16, a firm would receive more credit in 1988-1993 than the analysis indicates.

Description of S. 2484

The major distinction between S. 2484 and current law lies in the calculation of the base, upon which the credit is determined. S. 2484 utilizes a fixed-base, the so-called "historic base period amount," which freezes a firm's historic spending level. Current law, on the other hand, uses a moving-base, which is calculated with reference to a firm's expenditures for the three immediately preceding years. A firm's fixed-base under S. 2484 would be equal to its average annual R & E expenditure in 1983 through 1987 plus 7%. Beginning in 1990 this base amount would be indexed by annual increases in GNP. One important restriction is that it can never be less than 50% of current expenditures when calculating a firm's credit.

Once the historical base period amount is determined, a firm has a choice of calculating its credit one of two ways: it can subtract its current R & E expenditures from its base and take 20% of the difference as its credit; or, it can subtract its current R & E expenditures from 75% of its base and take 7% of the difference as its credit. The latter calculation is referred to as either the "alternative credit calculation" or the "secondary credit". A firm can switch from one type of credit calculation to the other in any taxable year, depending upon which is most advantageous.

Section 5 of S. 2484 would make most start-up firms eligible for the credit. Firms which did not have R & E expenditures in at least two years during the period between 1983 and 1987, including firms which come into existence after 1988, would calculate their R & E base as described below. For a firm's first three years of R&E spending the base would be zero. In the fourth year, the base would equal one-third of the average R & E spending in the first three years. In the fifth year, the base would equal the fourth year base plus 15% of fourth year R & E expenditures. In the sixth year, the base would equal the fifth year base plus 15% of fifth year R & E expenditures. Thereafter, the "historical base period amount" would be fully phased in, and the base would be increased by annual GNP growth. Start-up firms would also be subject to the 50% of current expenditures base limitation.

Established Firms

- Table 1 represents fast-growth firms that increase their R & E spending at a rate of 12 percent.
- Table 2 represents medium-growth firms that increase their R & E spending at a rate of 7 percent.
- Table 3 represents slow-growth firms that increase their R & E spending at rate of 3 percent.
- Table 4 represents firms that decrease their R & E spending at a rate of 3 percent annually.
- Table 5 represents firms that decrease their R & E spending at a rate of 1 percent annually.
- Table 6 represents firms that maintain a constant R & E spending level.

- Table 7 represents firms with mildly cyclical R & E spending patterns.
- Table 8 represent firms with highly cyclical R & E spending patterns.

Start-Up Firms:

- Table 9 represents fast-growth start-up firms that increase their R & E spending at a rate of 12 percent.
- Table 10 represents medium-growth start-up firms that increase their R & E spending at a rate of 7 percent.
- Table 11 represents slow-growth start-up firms that increase their R & E spending at rate of 3 percent.
- Table 12 represents start-up firms that decrease their R & E spending at a rate of 3 percent annually.
- Table 13 represents start-up firms that decrease their R & E spending at a rate of 1 percent annually.
- Table 14 represents start-up firms that maintain a constant R & E spending level.
- Table 15 represents start-up firms with mildly cyclical R & E spending patterns.
- Tables 16 represents start-up firms with highly cyclical R & E spending patterns.

Notes

On all tables, R & E spending is given in thousands of dollars. The column labeled "Credit $ Current Law" displays the tax credit which will result from current law for the indicated year and R & E spending level. The column labeled "Base Primary GNP = 2.5%" displays the "base" as calculated under S.2484 for hypothetical firms electing the "primary credit", taking into consideration the firm's historical R & E spending levels. The column labeled "Credit $ Primary 20%" indicates the tax credit that would result from the base calculation under the bill as determined above. The column labeled "Credit $ Secondary 7% + 75% of Base" indicates the tax credit that would result from electing the "alternative credit calculation" described in S.2484. "Maximum Credit $ Available" calculates the firm's optimal return from the new credit, assuming the firm switches between the primary and secondary credit at the most propitious time. The amount designated as "Total Credit" at the bottom of each Table indicates the combined total credit amounts for the particular spending pattern under both current law and S.2484, for the years 1989 through 1993. It is used as a rough gauge or a scoreboard of the relative advantages of on system over another.

On tables 9-16, the column "Maximum Credit $ Allowable" represent the greatest credit a firm could receive in a particular year if the firm was limited only by the 50% of current expenditure restriction contained in Section 3 of the bill. For example, a firm spending $250,000 dollars in R & E has a maximum credit of $25,000 - which is 50% of its current spending at the 20% credit rate. This column is different from "Maximum Credit Available" which represents a firm's optimal credit calculation - the primary or secondary credit.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

Table 1: Fast Growth Firm (+12%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1983	105.55					
1984	119.94					
1985	136.29					
1986	154.88	6.86				
1987	176.00	7.79				
1988	200.00	8.86				
1989	224.00	9.41	172.65	10.27	6.62	10.27
1990	250.88	10.18	176.97	14.78	8.27	14.78
1991	280.99	11.21	181.39	19.92	10.15	19.92
1992	314.70	12.55	185.93	25.76	12.27	25.76
1993	352.47	14.06	190.58	32.38	14.67	32.38
Total Credit ('89 to '93)		57.39		103.11	51.97	103.11

Table 2: Medium Growth Firm (+7%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1983	139.14					
1984	149.61					
1985	160.87					
1986	172.98	4.62				
1987	186.00	4.97				
1988	200.00	5.34				
1989	214.00	5.53	190.72	4.66	4.97	4.97
1990	228.98	5.80	195.48	6.70	5.77	6.70
1991	245.01	6.14	200.37	8.93	6.63	8.93
1992	262.16	6.57	205.38	11.36	7.57	11.36
1993	280.51	7.03	210.52	14.00	8.58	14.00
Total Credit ('89 to '93)		31.06		45.64	33.52	45.96

Table 3: Slow Growth Firm (+3%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1983	171.75					
1984	177.06					
1985	182.53					
1986	188.18	2.21				
1987	194.00	2.28				
1988	200.00	2.35				
1989	206.00	2.39	206.58	0.00	3.57	3.57
1990	212.18	2.44	211.74	0.09	3.74	3.74
1991	218.55	2.50	217.04	0.30	3.90	3.90
1992	225.10	2.57	222.46	0.53	4.08	4.08
1993	231.85	2.65	228.02	0.77	4.26	4.26
Total Credit ('89 to '93)		12.54		1.68	19.55	19.55

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Table 4: Negative Growth Firm (-3%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit $ Secondary 7% 75% of Base	Maximum Credit $ Available
1983	231.85					
1984	225.10					
1985	218.55					
1986	212.18	0.00				
1987	206.00	0.00				
1988	200.00	0.00				
1989	194.00	0.00	232.91	0.00	1.35	1.35
1990	188.18	0.00	238.73	0.00	0.64	0.64
1991	182.53	0.00	244.70	0.00	0.00	0.00
1992	177.06	0.00	250.82	0.00	0.00	0.00
1993	171.75	0.00	257.09	0.00	0.00	0.00
Total Credit ('89 to '93)		0.00		0.00	1.99	1.99

Table 5: Negative Growth Firm (-1%)

Year of R&E Spending	R&E Spending Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1983	210.20					
1984	208.12					
1985	206.06					
1986	204.02	0.00				
1987	202.00	0.00				
1988	200.00	0.00				
1989	198.00	0.00	223.78	0.00	2.11	2.11
1990	196.02	0.00	229.38	0.00	1.68	1.68
1991	194.06	0.00	235.11	0.00	1.24	1.24
1992	192.12	0.00	240.99	0.00	0.80	0.80
1993	190.20	0.00	247.01	0.00	0.35	0.35
Total Credit ('89 to '93)		0.00		0.00	6.18	6.18

Table 6: Zero Growth Firm

Year of R&E Spending	R&E Spending Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1983	200.00					
1984	200.00					
1985	200.00					
1986	200.00	0.00				
1987	200.00	0.00				
1988	200.00	0.00				
1989	200.00	0.00	219.35	0.00	2.48	2.48
1990	200.00	0.00	224.83	0.00	2.20	2.20
1991	200.00	0.00	230.45	0.00	1.90	1.90
1992	200.00	0.00	236.22	0.00	1.60	1.60
1993	200.00	0.00	242.12	0.00	1.29	1.29
Total Credit ('89 to '93)		0.00		0.00	9.47	9.47

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Table 7: Mildly Cyclical Spending Firm

Year of R&E Spending	R&E Spending Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1983	175.00					
1984	150.00					
1985	125.00					
1986	165.00	3.00				
1987	180.00	6.67				
1988	200.00	8.67				
1989	175.00	0.00	179.87	0.00	2.81	2.81
1990	150.00	0.00	184.36	0.00	0.82	0.82
1991	125.00	0.00	188.97	0.00	0.00	0.00
1992	165.00	3.00	193.70	0.00	1.38	1.38
1993	180.00	6.67	198.54	0.00	2.18	2.18
Total Credit ('89 to '93)		9.67		0.00	7.19	7.19

Table 8: Highly Cyclical Spending Firm

Year of R&E Spending	R&E Spending Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1983	25.00					
1984	115.00					
1985	235.00					
1986	50.00	0.00				
1987	75.00	0.00				
1988	200.00	16.00				
1989	100.00	0.00	148.06	0.00	0.00	0.00
1990	45.00	0.00	151.76	0.00	0.00	0.00
1991	250.00	25.00	155.56	18.89	9.33	18.89
1992	180.00	9.67	159.45	4.11	4.23	4.23
1993	65.00	0.00	163.43	0.00	0.00	0.00
Total Credit ('89 to '93)		34.67		23.00	13.56	23.12

Table 9: Fast Growing Start-up Firm (+12%)

Year of R&E Spending	R&E in Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Maximum Credit $ Allowable	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	119.94	11.99	0.00	11.99	11.99	8.40	11.99
1985	136.29	3.27	0.00	13.63	13.63	9.54	13.63
1986	154.88	5.35	0.00	15.49	15.49	10.84	15.49
1987	176.00	7.79	46.82	17.60	17.60	9.86	17.60
1988	200.00	8.86	74.39	20.00	20.00	10.09	20.00
1989	224.00	9.41	106.25	22.40	22.40	10.10	22.40
1990	250.88	10.18	108.91	25.09	25.09	11.84	25.09
1991	280.99	11.21	111.63	28.10	28.10	13.81	28.10
1992	314.70	12.55	114.42	31.47	31.47	16.02	31.47
1993	352.47	14.06	117.28	35.25	35.25	18.52	35.25
Total Credit ('89 to '93)		57.39		142.31	142.31	70.29	142.31

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Table 10: Medium Growth Start-up Firm (+7%)

Year of R&E Spending	R&E in Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Maximum Credit $ Allowable	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	149.61	14.96	0.00	14.96	14.96	10.47	14.96
1985	160.87	2.25	0.00	16.09	16.09	11.26	16.09
1986	172.98	3.55	0.00	17.30	17.30	12.11	17.30
1987	186.00	4.97	55.06	18.60	18.60	10.13	18.60
1988	200.00	5.34	84.34	20.00	20.00	9.57	20.00
1989	214.00	5.53	116.45	21.40	19.51	8.87	19.51
1990	228.98	5.80	119.36	22.90	21.92	9.76	21.92
1991	245.01	6.14	122.34	24.50	24.50	10.73	24.50
1992	262.16	6.57	125.40	26.22	26.22	11.77	26.22
1993	280.51	7.03	128.54	28.05	28.05	12.89	28.05
Total Credit ('89 to '93)		31.06		123.07	120.20	54.01	120.20

Table 11: Slow Growth Start-up Firm (+3%)

Year of R&E Spending	R&E in Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Maximum Credit $ Allowable	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	177.06	17.71	0.00	17.71	17.71	12.39	17.71
1985	182.53	1.10	0.00	18.25	18.25	12.78	18.25
1986	188.18	1.68	0.00	18.82	18.82	13.17	18.82
1987	194.00	2.28	62.39	19.40	19.40	10.30	19.40
1988	200.00	2.35	93.04	20.00	20.00	9.12	20.00
1989	206.00	2.39	125.37	20.60	16.13	7.84	16.13
1990	212.18	2.44	128.51	21.22	16.73	8.11	16.73
1991	218.55	2.50	131.72	21.85	17.36	8.38	17.36
1992	225.10	2.57	135.02	22.51	18.02	8.67	18.02
1993	231.85	2.65	138.39	23.19	18.69	8.96	18.69
Total Credit ('89 to '93)		12.54		109.37	86.93	41.96	86.93

Table 12: Negative Growth Start-up Firm (-3%)

Year of R&E Spending	R&E in Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Maximum Credit $ Allowable	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	225.10	22.51	0.00	22.51	22.51	15.76	22.51
1985	218.55	0.00	0.00	21.85	21.85	15.30	21.85
1986	212.18	0.00	0.00	21.22	21.22	14.85	21.22
1987	206.00	0.00	74.69	20.60	20.60	10.50	20.60
1988	200.00	0.00	107.46	20.00	18.51	8.36	18.51
1989	194.00	0.00	140.15	19.40	10.77	6.22	10.77
1990	188.18	0.00	143.65	18.82	8.91	5.63	8.91
1991	182.53	0.00	147.24	18.25	7.06	5.05	7.06
1992	177.06	0.00	150.92	17.71	5.23	4.47	5.23
1993	171.75	0.00	154.70	17.17	3.41	3.90	3.90
Total Credit ('89 to '93)		0.00		91.35	35.37	25.27	35.87

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Table 13: Negative Growth Start-up Firm (-1%)

Year of R&E Spending	R&E in Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Maximum Credit $ Allowable	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	208.12	20.81	0.00	20.81	20.81	14.57	20.81
1985	206.06	0.00	0.00	20.61	20.61	14.42	20.61
1986	204.02	0.00	0.00	20.40	20.40	14.28	20.40
1987	202.00	0.00	70.41	20.20	20.20	10.44	20.20
1988	200.00	0.00	102.47	20.00	19.51	8.62	19.51
1989	198.00	0.00	135.03	19.80	12.59	6.77	12.59
1990	196.02	0.00	138.40	19.60	11.52	6.46	11.52
1991	194.06	0.00	141.86	19.41	10.44	6.14	10.44
1992	192.12	0.00	145.41	19.21	9.34	5.81	9.34
1993	190.20	0.00	149.04	19.02	8.23	5.49	8.23
Total Credit ('89 to '93)		0.00		97.04	52.12	30.67	52.12

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Table 14: Zero Growth Start-up Firm

Year of R&E Spending	R&E in Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Maximum Credit $ Allowable	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	200.00	20.00	0.00	20.00	20.00	14.00	20.00
1985	200.00	0.00	0.00	20.00	20.00	14.00	20.00
1986	200.00	0.00	0.00	20.00	20.00	14.00	20.00
1987	200.00	0.00	68.33	20.00	20.00	10.41	20.00
1988	200.00	0.00	100.04	20.00	19.99	8.75	19.99
1989	200.00	0.00	132.54	20.00	13.49	7.04	13.49
1990	200.00	0.00	135.86	20.00	12.83	6.87	12.83
1991	200.00	0.00	139.26	20.00	12.15	6.69	12.15
1992	200.00	0.00	142.74	20.00	11.45	6.51	11.45
1993	200.00	0.00	146.31	20.00	10.74	6.32	10.74
Total Credit ('89 to '93)		0.00		100.00	60.66	33.42	60.66

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Table 15: Mildy Cyclical Spending Start-up Firm

Year of R&E Spending	R&E in Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Maximum Credit $ Allowable	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	150.00	15.00	0.00	15.00	15.00	10.50	15.00
1985	125.00	0.00	0.00	12.50	12.50	8.75	12.50
1986	165.00	5.50	0.00	16.50	16.50	11.55	16.50
1987	180.00	6.67	50.11	18.00	18.00	9.97	18.00
1988	200.00	8.67	78.36	20.00	20.00	9.89	20.00
1989	175.00	0.00	110.32	17.50	12.94	6.46	12.94
1990	150.00	0.00	113.08	15.00	7.38	4.56	7.38
1991	125.00	0.00	115.91	12.50	1.82	2.66	2.66
1992	165.00	3.00	118.81	16.50	9.24	5.31	9.24
1993	180.00	6.67	121.78	18.00	11.64	6.21	11.64
Total Credit ('89 to '93)		9.67		79.50	43.02	25.21	43.86

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Table 16: Highly Cyclical Spending Start-up Firm

Year of R&E Spending	R&E in Thousands of Dollars	Credit $ Current Law	Base Primary GNP - 2.5%	Maximum Credit $ Allowable	Credit $ Primary 20%	Credit $ Secondary 7% + 75% of Base	Maximum Credit $ Available
1984	115.00	11.50	0.00	11.50	11.50	8.05	11.50
1985	235.00	24.00	0.00	23.50	23.50	16.45	23.50
1986	50.00	0.00	0.00	5.00	5.00	3.50	5.00
1987	75.00	0.00	45.56	7.50	5.89	2.86	5.89
1988	200.00	16.00	57.94	20.00	20.00	10.96	20.00
1989	100.00	0.00	89.39	10.00	2.12	2.31	2.31
1990	45.00	0.00	91.63	4.50	0.00	0.00	0.00
1991	250.00	25.00	93.92	25.00	25.00	12.57	25.00
1992	180.00	9.67	96.27	18.00	16.75	7.55	16.75
1993	65.00	0.00	98.67	6.50	0.00	0.00	0.00
Total Credit ('89 to '93)		34.67		64.00	43.87	22.42	44.06

ATTACHMENT 3

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Date: October 29, 1987

To: Dan Mastromarco, Mark Hankins

From: Bill Scheirer who

Subject: Tax Credit if R&D Expenditures Increase by Same Number of Dollars Every Year

If a firm's R&D has increased and will continue to increase by the same number of dollars every year, the annual R&D tax credit (at a rate of 20 percent) will be 40 percent of the annual increase in R&D. The algebraic proof is as follows. Let:

$R(t)$ = R&D in year t
X = annual increase in R&D
$B(t)$ = base in year t for the R&D tax credit
$C(t)$ = tax credit in year t

$$\begin{aligned}
\text{Now}\quad B(t) &= 1/3(R(t-1)+R(t-2)+R(t-3)) \\
\text{or}\quad 3B(t) &= R(t-1)+R(t-2)+R(t-3) \\
&= X+R(t-2)+R(t-2)+R(t-3) \\
&= X+X+R(t-3)+X+R(t-3)+R(t-3) \\
&= 3X+3R(t-3) \\
\text{or}\quad B(t) &= X+R(t-3) \\
&= R(t-2)
\end{aligned}$$

$$\begin{aligned}
\text{Then}\quad C(t) &= 0.2(R(t)-B(t)) \\
\text{or}\quad 5C(t) &= R(t)-B(t) \\
&= X+R(t-1)-R(t-2) \\
&= X+X+R(t-2)-R(t-2) \\
&= 2X \\
\text{or}\quad C(t) &= 0.4X
\end{aligned}$$

cc: Tom Gray
Charles Ou
Bill Whiston

Date: October 30, 1987

To: Dan Mastromarco, Mark Hankins

From: Bill Scheirer

Subject: Maximum Constant Percentage Growth in R&D Expenditures without Surpassing Ceiling on R&D Funds Eligible for Tax Credit

If a firm's R&D has increased and will continue to increase by the same percentage every year, the annual R&D tax credit will be at the allowable ceiling for a constant annual increase of 45 percent in R&D. The proof is as follows. Let r denote the ratio of each year's R&D to the previous year's R&D. With a 10 percent growth rate, r will be 1.1; with a 20 percent growth rate, r will be 1.2; etc. Also let:

$R(t)$ = R&D in year t
$B(t)$ = base in year t for the R&D tax credit
m = R&D as a multiple of the base

$$\begin{aligned} \text{Now}\quad B(t) &= 1/3(R(t-1)+R(t-2)+R(t-3)) \\ \text{or}\quad 3B(t) &= R(t-1)+R(t-2)+R(t-3) \\ &= rR(t-2)+R(t-2)+R(t-3) \\ &= r^2R(t-3)+rR(t-3)+R(t-3) \\ &= (r^2+r+1)R(t-3) \end{aligned}$$

$$\begin{aligned} \text{Then}\quad m &= R(t)/B(t) \\ &= 3R(t)/3B(t) \\ &= 3rR(t-1)/3B(t) \\ &= 3r^2R(t-2)/3B(t) \\ &= 3r^3R(t-3)/(r^2+r+1)R(t-3) \\ &= 3r^3/(r^2+r+1) \\ &= 3r^3(r^2+r+1)^{-1} \end{aligned}$$

Now m increases as r increases. That is, the derivative of m with respect to r is positive for positive r:

$$dm/dr = 9r^2(r^2+r+1)^{-1}-3r^3(r^2+r+1)^{-2}(2r+1)$$

We can multiply by $(r^2+r+1)^2$ and divide by r^2 without changing the sign of the derivative. So the sign of dm/dr will be the same as the sign of

$$\begin{aligned} &9(r^2+r+1)-3r(2r+1) \\ =\ &9r^2+9r+9-6r^2-3r \\ =\ &3r^2+6r+9 \end{aligned}$$

If r is positive, this quantity is positive. As r increases, m increases and has a value of 2 for only one positive r. If r is 1.445, m is 1.997. If r is 1.455, m is 2.021. Thus if m is 2, r is between 1.445 and 1.455, or 1.45 to two decimals.

R&D as a multiple of the base is not allowed to be greater than 2 in calculating the allowed tax credit. This corresponds to a constant annual growth rate of 45 percent in R&D.

cc: Tom Gray
Charles Ou
Bill Whiston

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Date: November 24, 1987

To: Dan Mastromarco, Mark Hankins

From: Bill Scheirer

Subject: Present Value of Tax Credit for a Firm with a Permanent Increase in R&D Spending

If a firm's R&D has been at a constant level of X dollars per year, then increases to a new level of (X + Y) dollars per year, and stays at the new level, the firm will be eligible for an R&D tax credit (at a rate of 20 percent) for three years and the present value of the tax credits will be 3.42 percent of the present value of the R&D increase (Y dollars) in all future years. The algebra is as follows. Let:

$R(t)$ = R&D in year t
$B(t)$ = base in year t for the R&D tax credit
$C(t)$ = tax credit in year t
T = first year of the increased R&D

Then $R(t) = X$ for $t<T$
$R(t) = X+Y$ for $t \geq T$

$$\begin{aligned}
B(T) &= 1/3(R(T-1)+R(T-2)+R(T-3)) \\
&= 1/3\ (X+X+X) \\
&= 1/3\ (3X) \\
&= X \\
C(T) &= 0.2(R(T)-B(T)) \\
&= 0.2\ (X+Y-X) \\
&= 0.2Y
\end{aligned}$$

$$\begin{aligned}
B(T+1) &= 1/3(R(T)+R(T-1)+R(T-2)) \\
&= 1/3\ (X+Y+X+X) \\
&= 1/3\ (3X+Y) \\
&= X+Y/3 \\
C(T+1) &= 0.2(R(T+1)-B(T+1)) \\
&= 0.2(X+Y-X-Y/3) \\
&= 0.2(2Y/3) \\
&= 0.4Y/3
\end{aligned}$$

$$\begin{aligned}
B(T+2) &= 1/3(R(T+1)+R(T)+R(T-1)) \\
&= 1/3(X+Y+X+Y+X) \\
&= 1/3(3X+2Y) \\
&= X+2Y/3 \\
C(T+2) &= 0.2(R(T+2)-B(T+2)) \\
&= 0.2(X+Y-X-2Y/3) \\
&= 0.2Y/3
\end{aligned}$$

$$\begin{aligned}
B(T+3) &= 1/3(R(T+2)+R(T+1)+R(T)) \\
&= 1/3\ (X+Y+X+Y+X+Y) \\
&= 1/3(3X+3Y) \\
&= X+Y
\end{aligned}$$

```
C(T+3) = 0.2(R(T+3)-B(T+3))
       = 0.2(X+Y-X-Y)
       = 0
```

There are tax credits for the years T, T+1, and T+2. The simple sum of these three credits is:

```
      0.2Y+0.4Y/3+0.2Y/3
    = 0.6Y/3+0.4Y/3+0.2Y/3
    = 1.2Y/3
    = 0.4Y
```

However, a later credit is not as good as a credit that can be taken sooner. This is an example of the rationale for the concept of present value. OMB Circular A-94 prescribes a discount rate of 10 percent. We would divide the credit in year (T+2) by 1.1 to get its value in year (T+1), and divide any values in year (T+1) by 1.1 to get their present value in year T. Thus, the present value in year T of the tax credits for the years T, T+1, and T+2 is:

```
      0.2Y+0.4Y/3/1.1+0.2Y/3/1.1/1.1
    = 0.376Y
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or a little less than the simple sum of the three credits. At a discount rate of 10 percent, the present value in year T of the R&D increase (Y dollars) for T and all years into the infinite future is 11 times Y (proof omitted). The present value of the credits is thus 3.42 percent of the present value of the R&D increase in all future years.

cc: Tom Gray
Dave Hirschberg
Charles Ou
Bill Whiston

STATEMENT BY CONGRESSMAN BILLY TAUZIN

before the
Senate Finance Subcommittee
on
Taxation and Debt Management
on S. 1821

Mr. Chairman, I appreciate this opportunity to submit a written statement on S. 1821, legislation to insure that the U.S. seafood processing industry will not be burdened with unwarranted and unnecessary administrative costs. The seafood processing industry is vital to the economy of Louisiana and other coastal states, and that vitality is threatened by a policy recently announced by the Internal Revenue Service.

Specifically, Mr. Chairman, the IRS for many years has issued official determination letters stating that individuals who process seafood -- who bone fish, remove seafood from its shell, or head shrimp -- are not "employees" for federal income tax purposes. Now the IRS has reversed that position, has notified Louisiana seafood processing companies that it now views these individuals as employees, and has threatened severe penalties against companies that do not treat these individuals as employees. This new policy, which directly contradicts previous IRS rulings and is contrary to standard industry practice, would result in the imposition of completely unreasonable administrative costs and burdens on the seafood processing industry.

The individuals who perform seafood processing activities simply do not resemble the typical "employee". These individuals do not receive a fixed wage, but instead are paid on the basis of the quantity of seafood they process. By habit and temperament, these individuals also are highly mobile, and frequently will move around a state or even the country as they perceive more desirable employment opportunities. They are free to come and go at will and exercise their own discretion as to number of hours worked.

In short, these individuals are self-employed. Because of their mobile and flexible work habits, even a very small processing plant may well use the services of over 100 such individuals in the course of a year. Obviously, it would be difficult and impractical for a processing plant to keep the necessary records to calculate its tax obligations as an employer and equally difficult for it to withhold appropriate taxes for payment. Yet the IRS policy would impose just such a burden, a burden that may well force our smaller processing companies out of business.

We have long recognized that mobile individuals compensated on the basis of goods produced should not be treated as employees under our Tax Code.

The legislation that my colleague Senator Breaux has proposed and I have proposed in the House would ensure the continued application of this policy in the seafood processing industry so that the industry is not saddled with impossible administrative burdens.

Mr. Chairman, I appreciate your consideration in this issue and hope that the Subcommittee will favorably move this legislation forward.

STATEMENT OF R.J. VOGEL
CHIEF BENEFITS DIRECTOR
VETERANS ADMINSTRATION
BEFORE THE
SENATE FINANCE
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

JULY 12, 1988

Mr. Chairman and Members of the Committee:

I am pleased to be here today to present the views of the Veterans Administration on S. 2611, 100th Congress. These views represent solely the position of the Veterans Administration (VA). The Office of Management and Budget has advised that the Administration's position on this bill is under development. The bill is "To amend the Internal Revenue Code of 1986 to provide for the disclosure of income information to the Veterans Administration for purposes of verifying information provided about their incomes by beneficiaries of programs under which income is relevant to eligibility; and to amend title 38, United States Code, to protect against the misuse of such information, and for other purposes."

For the reasons that follow, the VA supports enactment of S. 2611.

The subject bill would amend the Internal Revenue Code of 1986 so as to authorize the Veterans Administration (VA) to use Internal Revenue Service (IRS) Federal tax return information to verify eligibility in certain veterans benefits programs which are affected by income. The VA programs specifically mentioned in the bill are: needs-based pension; parents' dependency and indemnity compensation; means-tested health care services; and, compensation pursuant to a rating of total disability due to inability to secure gainful employment. We believe that the integrity of all of these programs would be significantly improved if IRS return information were made available because the IRS information would give the Agency the opportunity to independently verify the income data provided by a VA program applicant or beneficiary. The most detailed and extensive consideration of the value of the availability of the IRS information has occurred in one of the largest of the mentioned programs, the pension program.

Currently, the VA provides an income based or "means test" pension benefit to veterans permanently and totally disabled (38 U.S.C. § 521), their surviving spouses (38 U.S.C. § 541), or their surviving children (38 U.S.C. § 542).

On an annual basis, the Agency reviews the continued elegibility of persons receiving pension benefits. This review determines whether the annual amount of that benefit, which under current law is reduced $1 for $1 based on income, should be adjusted according to changes in an individual's income.

The method used for verifying income is to require those individuals receiving pension benefits to submit an annual income report listing all sources and amounts of income.

As indicated by the Grace Commission Report, "The pension area, in particular, could contain many errors caused by incomplete reporting, misinterpretation of the AIQ forms, or fraud" (Commission Report, "Report on the Veterans Administration," 1983, at p. 26). Thus, the Commission suggested in Recommendation No. VA 2-2 (p. 27 of the report) that the VA pursue all possible computer matching opportunities.

The Agency has already established regular computer matching of income data with other Federal entities such as the Social Security Administration (SSA) and the Office of Personnel Management. (Parenthetically, we note that the VA is not currently obtaining any data from the SSA which is subject to 26 U.S.C. § 6103. The data exchange which we have been pursuing for years with the SSA is limited to exchange of VA and SSA benefit payment information.) These matches and various audits by the VA Inspector General have tended to confirm the suspicions of the Grace Commission, but the matches are not adequate for comprehensive determination of outside income. Moreover, not all possibilities for verifying pension income reports have been legally available for exploration. The VA, without access to IRS taxpayer records and IRS information return records, remains unable to monitor effectively and to verify income from private sources, such as wages, interest, or retirement benefits. With access to IRS information, the VA would be in a better position to detect fraud and control possible issuance of incorrect payments. This was validated in two recent GAO reports which concluded in both instances that Congress should consider amending the Internal Revenue Code of 1954 (26 U.S.C. § 6103(l)(7) to grant VA access (i.e., for purposes of verifying income reported by pension beneficiaries and by applicants for VA compensation benefits based upon unemployability) to the same earned and unearned income information that the Deficit Reduction Act of 1984, Pub. L. No. 98-369, (DEFRA) authorizes seven other Federal benefit programs to receive. Those conclusions came from analyzing the detailed, quantitative results derived from computer matching of a representative sample of VA pension and compensation records with IRS return information. The first report, "VETERANS BENEFITS: Improving the Integrity of the VA's Unemployability Compensation Program," was completed in September 1987. The second GAO report, "VETERANS PENSIONS:

Using Tax Data to Verify Income Can Identify Significant Potential Erroneous Payments," was completed in March 1988. The cost effectiveness of such matching was amply supported by the data which revealed that in the first report, potential overpayments to veterans who should have reported their earnings to the VA in 1984 and 1985 could have exceeded $10 million with only a relatively small $65,000 data processing cost.

In the second report GAO found that with access to tax data the VA would have been able to identify $157.2 million in potential overpayments to 134,200 pension beneficiaries in 1984. The GAO estimated that the cost effectiveness of using tax data to verify income reported by pension beneficiaries to the VA (i.e., in the annual self-reporting questionnaire form the Agency solicits from those beneficiaries) was at a favorable ratio of 11:1.

In light of the foregoing, we believe that justification exists for expanding IRS authority to disclose tax return information to the VA for purposes of determining eligibility and payment amounts for pension and other benefits. State and local agencies currently access IRS information for use in verifying eligibility and correct payment amounts for certain Federally funded benefits programs. Certainly, the VA, a Federal agency, should be afforded access to IRS return information in order to make such determinations in similar Federally funded income-based programs. The VA pension benefits program had a Fiscal Year 1988 budget of approximately $3.9 billion. Although it is impossible to project a reliable figure for cost savings due solely to VA access to IRS return information, we strongly believe the potential exists for realizing significant cost savings for the VA pension and other mentioned programs over the next 5 years with VA access to IRS return information.

These savings would be recovered both through the prevention of future overpayments (i.e., cost avoidance) and from the actual collection of the substantial amount of receivables created from past overpayments. With respect to overpayments, an efficient and effective means of actual collection is available. In cases where overpayment results in the reduction rather than termination of benefits, the overpayment can simply be offset against a claimant's future monthly benefits. Other traditional means of collection could be used in cases where benefits were terminated.

Our experience with computer matches of state wage and VA pension benefits information has involved several states (e.g., Georgia, Florida, Missouri, New York, Texas, Virginia, Maryland, Connecticut, Pennsylvania, Tennessee and Washington State), and has reinforced our belief that significant cost savings can be accomplished both from recoupment of overpayments and from cost avoidance. As a result of the computer matches of wage information from the states listed above, 17,951 cases were sent to VA regional offices for adjudicative review after earnings and employment status were confirmed with employers. With that process having been three-fourths completed as of March 17, 1988, the VA regional offices in those 10 states verified 5,754 erroneous payments totalling over $36 million in overpayments. Also documented were 2,366 cases in which cost avoidance through prevention of future overpayments would result in an annual savings of approximately $5.4 million. We expect to experience comparable results once this process has been completed. (Note: Of the total overpayments, over $31 million (or 68.2 percent), involving 3,929 cases was determined to have been received fraudulently.)

An aggressive approach to verifications, aided by IRS information, would prevent many overpayments and result in cost avoidance. This effect would directly result from claimants' knowledge of improved verification ability and their corresponding efforts to report correctly the income information on which their claims are initially or subsequently reviewed. The present misreporting should be halted to the fullest extent possible. We believe that access to IRS information for verification and for continuous monitoring will go a long way to achieving this end.

We understand that the Treasury Department has the following concerns: (1) disclosure of earnings information would undermine voluntary tax compliance, and (2) disclosure would violate taxpayer's privacy. We do not agree that VA access to tax data would adversely impact upon voluntary taxpayer compliance with the tax laws. The GAO observed that despite the IRS' stated interest in the general area of changes in voluntary taxpayer compliance as a result of authorizing access to tax data for nontax purposes, no studies exist or are underway to indicate what effect such access produces on voluntary compliance. Moreover, the GAO argues, the addition of 1.6 million VA pensioners to the more than 80 million recipients of Federal benefit programs for which access to income tax data currently exists should have "little incremental effect" on voluntary compliance. Further, we doubt that there would be 1.6 million new participants added. The tax information of many of these veteran pensioners is already being reported in food stamp and other DEFRA programs. The GAO did note, however, that studies have been conducted which reveal that use of tax data for tax enforcement purposes has a decidedly favorable impact. The public's knowledge that third-party reporting of income is required for verification purposes has improved (i.e., in 1986 by an estimated $2.7 billion) individual taxpayers' voluntary compliance with IRS's own income reporting requirements. The GAO anticipates that knowledge that income reported by VA pension beneficiaries in the annual self-reporting questionnaire would be subject to verification using third-party reported tax data should have a similar effect.

Concerning taxpayer privacy, we believe that records and information submitted to the Goverment by private citizens, whether acting as taxpayers, veterans, or otherwise, should be confidential. We believe additionally, however, that such confidentiality should not be absolute. Indeed, as indicated above, under certain circumstances confidentiality considerations should and do yield to other significant concerns, such as the maintenance of the integrity of Government benefit payment programs. We believe that the extension of IRS disclosure authority as recommended by GAO would not unwarrantedly invade the privacy of those taxpayers who participate in the VA disability compensation program. The veteran taxpayer would be treated no differently than those taxpayers participating in the DEFRA programs mentioned above.

The second GAO report squarely addressed the Treasury and IRS policy that alternate sources of income information must be exhausted prior to seeking IRS data. In this regard, the GAO observed that if the VA were to redesign the annual questionnaire, this would not be a substitute for independently verifying income using third-party reported tax data. Neither would requiring pension beneficiaries to annually submit to the VA copies of IRS form 1040 be acceptable because: (1) not all pension beneficiaries meet the minimum income necessary for filing a return; (2) the 1040 form would not provide independent verification of the accuracy of the income reported; and (3) VA access would be more intrusive of personal privacy in that details extraneous to the needs of the pension program would be unnecessarily disclosed. Further, the GAO acknowledged that resorting to quarterly wage information from the individual 50 states was impractical, even if all state agencies cooperated and data accuracy was ensured. (Moreover, some of the largest states, such as California and Ohio, will not cooperate.) For example, state wage data excludes earned income for the following categories of individuals: Federal military and civilian personnel, railroad workers, and the self-employed. Moreover, to obtain interest or dividend information (i.e., other than from the IRS form 1099 file) the VA would have the impossible task of identifying and contacting each and every bank or corporation involved with making such payments, and then be faced with the nondisclosure provisions of the Right to Financial Privacy Act of 1987 (Pub. L. No. 95-630) as to the financial institutions. Thus, we concur with these GAO examples which show that the IRS policy on requiring exhaustion of alternate sources of income information is neither practicable nor efficient.

In conclusion, the VA supports favorable enactment of this timely and important provision. As the foregoing testimony reveals, this bill would provide significant cost savings and reduce fraud in VA income-based benefits programs.

Thank you Mr.Chairman.

STATEMENT FOR THE RECORD OF
DAVID M. WALKER, CPA
ASSISTANT SECRETARY OF LABOR
PENSION AND WELFARE BENEFITS ADMINISTRATION
FOR THE HEARING ON S.2078
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

JULY 12, 1988

I. INTRODUCTION

We would like to thank you for the opportunity to submit the views of the Department of Labor on S.2078, a bill that would, among other things, provide for employee approval of the establishment of employee stock ownership plans (ESOPs).

The Department of Labor (The Department) has responsibility for the administration and enforcement of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Accordingly, the Department has a strong interest in issues related to employee pension and welfare benefit plans, especially those issues which involve fiduciary responsibility governed by Part 4 of Title I of ERISA. The Department of the Treasury did not comment on the fiduciary aspects of S.2078 in its July 12 testimony before the Committee because of the Department of Labor's primary responsibility in this area.

II. BACKGROUND

First, we would like to describe current provisions of Title I applicable to employee stock ownership plans. With certain exceptions, Part 4 of Title I of ERISA applies to all employee benefit plans. ERISA section 3(3) includes pension plans under the term employee benefit plans. An ESOP, which by its terms, or surrounding circumstances, defers income to retirement, or results in a deferral of income by employees for periods extending to termination of covered employment or beyond, is a pension plan. An ESOP is an individual account plan within the meaning of section 3(34) of ERISA, that is, it provides that assets held by the plan are to be allocated among individual accounts established for each participant. Upon retirement (or the occurrence of certain other events) the participant's benefits will be based solely on whatever assets are held in his or her account.

The decision of a plan sponsor to establish an ESOP (or any other type of pension plan) is not a fiduciary decision subject to review under ERISA section 404. However, once an ESOP has been established, ERISA section 404 requires that a fiduciary discharge his duties with respect to the plan in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of ERISA. If plan documents or instruments prescribe a course of action which is not consistent with ERISA, a trustee who engages in such action will violate ERISA. Section 404 also requires fiduciaries to discharge their duties with respect to the plan solely in the interest of the participants and beneficiaries and with the care, skill, prudence and diligence that a prudent man would use.

Among the key provisions of ERISA is the requirement that fiduciaries who are responsible for making decisions on behalf of employee benefit plans be identified. Section 403(a) of ERISA requires that assets be held in trust by one or more trustees who have exclusive authority and discretion to manage and control the assets of the plan. There are only two exceptions to the requirement that the trustees of a plan have exclusive authority over the management and disposition of assets of the plan. One exception is under section 403(a)(2), if the authority to manage, acquire, or dispose of plan assets is delegated to one or more properly appointed investment managers. The other is under section 403(a)(1), which provides that a plan may provide that the trustee is subject to the direction of a named fiduciary who is not a trustee. Such directions, however, must be proper and made in accordance with the terms of the plan. They also must not be contrary to ERISA.

A procedure for obtaining instructions from participants as to voting shares of employer securities held by an individual account plan and allocated to their accounts could be put into effect under section 403(a)(1) of ERISA only where directions received by the plan's trustee from the participants are proper and not contrary to ERISA. If plan documents or instruments prescribe a course of action inconsistent with ERISA, the trustee cannot engage in such action. Also, a trustee cannot carry out a procedure for obtaining participants' instructions if the trustee is aware that the decision rendered by participants is not independent or has been made under pressure.

Even where participant instructions are given in a manner that is not contrary to ERISA's provisions, the trustee remains responsible for certain matters such as assuring that the plan's provisions are implemented fairly, that information necessary to the participants is provided to them, and that information not be false or misleading. (In the event false or misleading information may have been distributed by other parties, the trustee has a duty to correct such information.) A trustee also remains responsible for determining whether a violation of ERISA would occur if participants' directions were followed.

It is the Department's view that an affirmative direction from a participant is necessary for section 403(a)(1) to apply. Therefore, a trustee cannot rely on a plan provision which provides that participants who do not specifically give instructions concerning the voting of shares allocated to their accounts be deemed to have issued a specific instruction regarding the voting of those shares. Where the trustee receives no directions from a participant with respect to a particular decision, section 403(a)(1) cannot apply. In those situations, the trustee bears exclusive responsibility for the decision and cannot merely vote the shares based on a formula or in proportion to the votes actually cast by the participants. Thus, for example, the responsibility of deciding whether to vote shares in a participant's account for or against a corporate recapitalization, given the participant's silence on the matter, would rest with the trustee. Of course, under this analysis, the trustee has the obligation to vote all unallocated shares on behalf of the trust.

Finally, as in all cases, the trustees must determine whether they have conflicts of interest which may interfere with the proper exercise of their responsibilities. If they do, it is the view of the Department that they should step aside in favor of trustees without such a conflict to decide the issue.

III. DISCUSSION OF S.2078

Now, we would like to turn to the proposal before the subcommittee, S. 2078. This bill would require a majority of employees to approve the establishment of an ESOP. It also would require that the approval be pursuant to an election conducted by secret ballot. Employees would be notified of all material facts concerning the plan, such facts to include a) whether the ESOP is replacing another plan and whether the assets from that plan will be transferred to the ESOP, b) the terms of the ESOP and c) the terms of the plan from which the assets are being transferred.

Under S.2078, the Secretary of the Treasury would be permitted to provide that the voting rights of participants required under section 409(e) of the Internal Revenue Code would not be satisfied unless the participants' voting rights in securities allocated to their accounts are substantially similar to the voting rights of other persons holding the same class of securities or substantially similar securities, regardless of whether the shares were registered or not.

As noted by the Department of Treasury's testimony, S.2078 would grant the Secretary of the Treasury the power to require ESOPs established in closely held corporations to allow participants to vote shares allocated to their accounts on all matters on which other shareholders of the same class of securities may vote. ESOPs holding publicly traded employer securities are already required to provide such equal voting rights to participants.

The Department of Labor's overriding concern is that the rights and benefits of participants and beneficiaries be adequately protected. We share Senator Armstrong's concern that employees' benefits not be endangered by the creation of ill-considered ESOPs, designed to aid one side or another in a struggle for corporate control. In light of this concern, we are in agreement with the underlying objective of S.2078, which is to safeguard employee rights.

The Department of Labor also supports the underlying purpose of S.2078's provisions designed to provide ESOP participants with the same stock ownership rights as other holders of similar classes of stock. We believe that it is appropriate to address the question of whether the existing ESOP rules provide employees with a degree of control consistent with beneficial ownership of their stock.

When an ESOP purchases securities from a party in interest, ERISA requires that no more than adequate consideration be paid, and that the terms of an ESOP loan be such that the plan assets would not be drained off. The loan must be primarily for the benefit of plan participants and beneficiaries and the interest rate charged cannot exceed a reasonable rate. Thus, properly structured ESOPs, at their inception, would be protective of the rights of participants in their ESOP benefits.

S.2078 would require a majority of employees to approve the establishment of an ESOP. We would note that this does not, in itself, provide ESOP participants with greater stock ownership rights. The issue of ownership rights is separate from the issue of whether employees should vote upon the establishment of an ESOP. In this regard, we are concerned that a vote on the creation of an ESOP would interfere with the discretion that an employer has traditionally enjoyed with respect to the establishment and termination of employee benefit plans. We prefer to see the issue of ownership rights addressed directly.

The Department of Labor supports policies that would place ESOPs that hold non-publicly traded securities on the same footing as those that hold registered securities. In lieu of granting regulatory authority in this area, we suggest that consideration be given to amending the appropriate provisions of the Internal Revenue Code governing the voting right protections contemplated here. We would propose that this be done in conjunction with a review of the existing inconsistencies between the Internal Revenue Code and Title I of ERISA regarding ESOPs.

The tax code has been amended several times without conforming ERISA amendments. As a result, some elective provisions of the Internal Revenue Code would allow (for tax qualification purposes) actions which would violate ERISA. For example, IRC section 409(e)(5) states that a plan may satisfy the tax qualification requirements concerning voting rights for ESOP participants if the plan grants each participant one vote and the trustee votes the shares held by the plan proportionally on the basis of the participants' votes. However under ERISA, the trustee in voting such securities would remain responsible for determining that participant directions regarding allocated shares are proper and for voting the unallocated shares without regard to participant directions, thus, in effect, rendering IRC section 409(e)(5) inoperative.

We are also concerned about a portion of Senator Armstrong's floor statement introducing the bill. Specifically, it is our understanding that the voting rights provisions of S.2078 may have been intended to override the trustee's ability to vote shares regardless of the directions the trustee receives from participants. We believe that the trustee's duty to determine whether the directions it receives are proper represents an important safeguard of ERISA's statutory scheme. As the Department has previously stated, a trustee could not accept instructions as proper if the trustee is aware that the participant's decision is not independent or has been made under pressure from the employer. The trustee also remains responsible for assuring that the plan's provisions are fairly implemented, that plan participants are provided necessary information, that clearly false or misleading information not be distributed to participants (or that such false or misleading information that may have been distributed is corrected), and remains responsible for determining whether following the instructions of the participants would result in a violation of Title I of ERISA. These participant protections should not be compromised. Any new safeguards should be in addition to the critical fiduciary provisions which currently exist.

The Department supports the bill's limitation on voting rights of plan participants and beneficiaries to securities allocated to their account. If the bill contemplates changing current laws to allow proportional voting of allocated stock as to which voting directions have not been received in accordance with voting directions received for allocated shares (subject to the trustee's duty to determine that such directions are proper), the Department would accept such a legislative change as not fundamentally inconsistent with ERISA's protections in this area. However, a trustee cannot and should not be allowed to evade its responsibility by relying on a procedure for proportional voting of stock held by a plan which has not yet been allocated to participant accounts. This position properly recognizes that plan participants and beneficiaries neither have beneficial ownership of such shares nor have particular expertise as to investments on behalf of the plan as a whole. Their directions as to unallocated shares could not and should not be considered proper under section 403(a) of ERISA.

In conclusion, we find that the bill's goal of providing equal voting rights to ESOP plan participants is commendable, especially in light of the fact that one of the stated goals of ESOP legislation has been to provide ESOP plan participants with an ownership stake in their companies. We would concur with the Department of Treasury that a more direct method of providing equivalent ownership rights would be preferable.

Pension Portability Testimony
by the
Profit Sharing Council of America

I am David Wray, President of the Profit Sharing Council of America (PSCA). The Council is a non-profit association which, since 1947, has represented companies that sponsor profit sharing plans. It is dedicated to the task of developing, collecting and communicating profit sharing information, and seeks to encourage the philosophy and practice of sharing profits with employees -- whose efforts make profits possible.

The PSCA represents over 1200 companies who employ over 1.75 million plan participants throughout the United States. PSCA members engage in every type of business activity and all regard profit sharing as a vital factor in their success. They range in size from a family-owned fledgling enterprise to the world's largest retailer. One member has shared profits for over 100 years, while other began only last month. All members depend upon the PSCA to represent and advocate their interests concerning current legislative and regulatory proposals that would affect profit sharing plans.

American business is increasingly recognizing the value of profit sharing. Studies in the United States and Great Britain have shown that companies with profit sharing outperform non-profit sharing companies.[1] Further, research by the Profit Sharing Council of America and Hewitt Associates over the 1973-1986 period found an average 11 percent of plan participants terminated for reasons other than retirement, death, or disability.[2] Compare this figure with the 21.6 percent of workers aged 25 or over who had been in their current job for a year or less in January of 1987.[3] Two recent academic studies also provide support for the greater labor force stability, and the resulting employment security, among companies with deferred profit sharing plans.[4]

In addition, the Profit Sharing Research Foundation compared the retirement benefits in large deferred profit sharing companies and found that deferred profit sharing provided greater retirement benefits than a typical final average salary defined benefit plan.[5] It is no wonder that companies practicing profit sharing have increased from under 200 prior to World War II to over 500,000 today.

It is the view of the Profit Sharing Council of America that restrictive "pension portability" legislation is unnecessary and, more importantly, it will reduce the incentive value of deferred profit sharing.

It has been stated "that pension plan asset accumulations under existing pension plans are increasingly being distributed at job termination or otherwise used for current consumption".[6] This is not the case for deferred profit sharing plans -- which are the vast majority of defined contribution plans. If anything, the passage of the Tax Reform Act of 1986, which eliminated 10-year averaging and imposed a 10 percent penalty on early withdrawals and termination distributions, appears to have resulted in a trend toward savings.

The data gathered by the May 1988 supplement to the Current Population Survey (CPS) will not be available for some time yet. However, the limited evidence from the 1983 CPS supplement, mobility patterns and benefit accrual pattern interactions, company experience, and the evidence for labor force stability among companies with deferred profit sharing suggests that the amounts of distributed pre-retirement lump sums are probably relatively small. This is certainly the experience of members of the Profit Sharing Council where most distributions are small. Only a small percentage of employees who leave a company prior to retirement have balances in excess of $5,000.

In the case of a small distribution, it makes no sense to force a recipient to hold the money in a tax deferred status. Fees for required reporting and other investment services will exceed the earnings on small amounts and eat up the principle. What is left will be substantially devalued by inflation. Recipients of larger amounts tend to be older, better educated, and with higher earning potential. As a result, they generally roll their distributions into IRAs to continue the tax deferred status for their funds and avoid the 10 percent penalty. They need not be forced to save their distributions.

Also, the distributions to terminated employees represent only a small fraction of the total assets in deferred profit sharing plans. For example, a large Council member with cliff vesting distributed only 0.5 percent of the plan assets in pre-retirement termination distributions. Another with immediate full vesting distributes about 5 percent. Overall, pre-retirement termination distributions probably represent between 2 and 3 percent of plan assets.

Unfortunately, the study[7] upon which much of the argument for restrictive "pension portability" legislation is based has limitations which reduce its value in addressing this issue. It is based on data collected prior to the passage of TRA '86. In addition, the questionnaire design anticipated that lump sum distributions would be large -- so the smallest precoded response was "Under $5000". Unfortunately, 84 percent of the actual responses fell into this category, so it was impossible to establish average or median values with any degree of certainty or to identify the underlying distribution of the lump sum values. Likewise, when queried about their use of the lump sums, 62 percent of the respondents indicated "Other". So the key questions -- how much and how was it used -- could only be discussed in a cursory fashion in the analysis. The most recent Current Population Survey has been designed to avoid these problems.

Two other problems were also present in the 1983 study: since the individual was not asked for the time period at which the lump sum was received, the results represented cumulative life experience rather than a measure of current activity. Finally, the 1983 survey was conducted during a period adjacent to a severe economic recession, possibly making the responses atypical of a broader time period.

The facts do not support the need for restrictive "pension portability" legislation.

It is interesting that most of the introduced legislation concerning "pension portability" focuses on defined contribution plans of which deferred profit sharing plans are the vast majority. The intent of this legislation is to prevent distribution from deferred plans or make such distributions as difficult as possible.

However, employers share profits with employees as an incentive for increased employee productivity. In order for there to be a productivity bang for the deferred profit sharing buck, the employee must feel ownership of the money. If the employee, especially a younger employee, learns that the profit sharing distribution to a deferred profit sharing plan is not available until age 59½, that employee will see that this distribution is merely a retirement benefit with no immediate meaning. The productivity incentive will be lost. This incentive has already been reduced by the limitations in the Tax Reform Act of 1986. It is the position of the Profit Sharing Council that this productivity incentive must be preserved if the deferred profit sharing system is to continue.

It should also be noted that employees who are changing jobs are more likely to accumulate benefits in a deferred profit sharing plan than other approaches. Specific contributions are made to an employee's account. This money belongs to the employee. This is important because, as shown in "Job Mobility and Private Pensions" published by the International Foundation of Employee Benefit Plans[8], job mobility has been excluded from traditional benefit accrual measurements in defined benefit plans. As the article says, "In order to get anything meaningful out of the private pension system one has to stay with a single employer most of one's working life." This is not necessarily true for employee who work for companies with deferred profit sharing.

Deferred profit sharing, because it typically involves larger contributions, vests more individuals at earlier points in their careers, and allows lump sum distributions, can be expected to contribute to pre-retirement lump sum distributions in greater proportion than the coverage in the general pension population.

Recent BLS data confirms that there has been little change in the overall job mobility patterns since 1968. Even the median white male still does not reach 10 years of tenure with his current job until after age 45.[9] Mobility is most prevalent among the younger workers, those with the lowest vesting and benefit accrual rates.

Deferred profit sharing needs to be encouraged so that employees, especially those young and mobile, have distributions to take with them when they change employment.

Also, the 1.75 million employees of the companies of the Profit Sharing Council do not want restrictive pension portability legislation. They want control of their money. However, the Profit Sharing Council has no objection to making it easier for terminating participants who wish to continue to defer their distributions to do so. For example, the Council does not object to making it easier to make plan-to-plan rollovers or rollovers into IRAs. The Council supports allowing terminated employees to roll their after-tax, as well as their pre-tax balances, into an IRA. The Council supports repealing the requirement that employers must maintain account balances for terminated employees whenever the amount is over $3500 and the employee has chosen not to take a final distribution at termination.

In conclusion, there is no "pension portability" problem for deferred profit sharing plans. In deferred profit sharing plans account balances are already portable. Distributions of any size are being retained voluntarily in tax deferred status. Most other distributions are so small that there is little value in keeping them tax deferred. Further, the price of forcing deferral of all distributions would be the sacrifice of the incentive value of profit sharing. The Profit Sharing Council of America urges that Congress not enact restrictive "pension portability" legislation.

Thank you for this opportunity to testify. I will be happy to answer any questions.

David L. Wray, President
Profit Sharing Council of America

Footnotes

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COMMUNICATIONS

AIRLINE ACQUISITION CORPORATION
P.O. Box 199, WINSTON-SALEM, NORTH CAROLINA 27102

July 25, 1988

Honorable Max Baucus, Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate
Washington, D.C. 20510

S. 2078 (S. 2291)

Dear Mr. Chairman:

We write to express our opposition to the portion of S. 2078 (S. 2291) that would require majority vote approval by all employees before an ESOP can be established. We do not oppose the portion of the Bill that would provide ESOP participants with the same stock ownership rights as other holders of similar classes of stock.

We oppose the formation vote requirement in principle and also because it appears to aim specifically at a transaction in which we are involved -- the employee ownership initiative at United Airlines. The United Airlines transaction is consistent with the historic purposes of ESOPs and hence does not warrant Congressional intervention.

Our primary objections to the formation vote portion of the Bill are the following:

1. S. 2078 would interfere with an employer's historic right to determine the compensation levels and benefit plans appropriate for its employees. There is today no statutory benefit plan in the country -- be it ESOP, pension, profit-sharing, etc. -- which requires an employee vote before it can be implemented. Union employees can, of course, vote directly or indirectly on their wages and benefits, through their elected union representatives. But non-union employees' wages and benefits are and always have been left to the discretion of management. It seems incredible

that Congress would reverse an important and fundamental principle of commerce by giving non-union employees the right to vote on whether to be covered by an ESOP -- and to help decide whether other groups can have an ESOP -- while denying non-union employees such a right with respect to any other type of wage or benefit arrangement, tax-advantaged or otherwise.

2. S. 2078 undermines the collective bargaining process and is inconsistent with federal labor laws. The Bill is effectively anti-union and a similar Bill in the House, H.R. 4184, has been emphatically opposed by the AFL-CIO on this basis. S. 2078 would allow one group of employees to veto another group's negotiated benefits. Moreover, the formation vote requirement would pass negotiated benefit decisions down to the union membership level, bypassing the collective bargaining agent, thereby intruding on well-established principles of collective bargaining.

3. S. 2078 favors corporate raiders over employee ownership plans. If the takeover specialists of this world want to take over a company and sell off units, dismiss employees, reduce wages, terminate pension plans, put in new plans, etc., they will remain free to do so. But if employees attempt to acquire their own company through an ESOP, they will be subject to the Bill's restrictive inhibitions.

4. ERISA already requires that the formation of an ESOP be supervised by a fiduciary faithful only to the interests of employees, a fiduciary who will consult with expert legal and financial advisors to insure that employees are treated fairly. Thus, existing law is sufficient to protect the interests of employees and a formation vote would in substance prove a distraction rather than provide a meaningful protection.

5. ESOPs have sometimes been formed in fast-moving contests for corporate control. S. 2078's formation vote requirement would in many cases impose a significant time delay on the establishment of an ESOP which might insure the failure of employee ownership -- rather than the success Congress contemplated -- in circumstances where employee ownership would be a welcome alternative to an incoming raider.

6. Senator Armstrong's floor statement introducing S. 2078 indicates that the Bill responds to concerns raised by some of his constituents about an ongoing ESOP transaction that would allegedly place employee pensions at risk. It appears virtually certain that the transaction reported to him was the ESOP initiative at United Airlines. But the employee ownership initiative at United Airlines has no intention of terminating or changing in any way the pension plans of non-union employees or using their pension money for an ESOP, and Senator Armstrong may have been given inaccurate information in this regard. As for union employees at United Airlines, their pensions will be considered and protected by the traditional collective bargaining process. Therefore, if pension security at an employee-owned United Airlines is one of the principal concerns, if not the primary concern to which the Bill responds, the vote formation portion of S. 2078 attempts to solve a problem that simply does not exist.

Sincerely,

William R. Howard

William R. Howard

AAD

July 14, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

American Advertising Distributors, Inc., believes this amendment would seriously hamper the creation of ESOP's to the detriment of employees of the affected employers. Further, the additional legislation will create massive additional regulation and complications to a process which is complex at present.

Sincerely,

Kenneth E. Williamson
Vice President-Finance & Administration

KEW/mfs

Enclosure

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

American Advertising Distributors, Inc. • 234 S. Extension, Mesa, AZ 85202 • P.O. Box AAD 16964, Mesa, AZ 85211
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July 11, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD205
Dirksen Senate Office Building
Washington, D.C. 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee press release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

My name is Ted Aprill, Jr., and I am writing you to ask your support in defeating the above enactment. I am President of Allied, Inc., an Ann Arbor, Michigan based company with over 200 employees and am currently in the process of implementing a company ESOP plan. My vision in life has been to see our company continue after I am gone and the ESOP gives me the opportunity to realize this dream.

If S.2078 is accepted, it would make it more time consuming and add to the cost of implementing an ESOP. Many small business owners like myself feel a moral responsibility to our employees to try and provide for their futures. An ESOP is one option we have to assure this.

My concern is that I have basically two options. One of which would be to sell the company. Both you and I know in many cases after the company is sold, the company is gutted and many of the loyal employees are let go. If I sold the company that would be my choice, but yet if I want to give the company to the employees, this enactment wants to delay or severely limit when and how I do it. This doesn't seem to make a lot of sense to me and I am sure to a lot of other business owners like myself.

I feel we should have our Senate looking for ways to improve the job market, and not trying to enact or delay programs that are in place to help the work force. Too many people are trying to restrict or delay ESOP enactments and are ignoring the real issues at hand.

Once again, I urge you to do everything in your power to defeat this proposal as a show of your concern for businesses around the country and their employees.

Sincerely,

Ted Aprill, Jr.
President

STATEMENT TO THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE ON THE MISCELLANEOUS REVENUE ACT OF 1988

Re: Extension of Section 127, the Exclusion for Employer-Provided Educational Assistance

"Education," stated President Lyndon B. Johnson, "is the guardian genius of democracy. Nothing really means more to our future."

National leaders of both parties have expressed a strong commitment to maintaining and improving our system of education. All agree that increased support by the private, as well as public, sectors is necessary if the United States is to remain technologically competitive in our rapidly changing world. However, in the past several years, we have witnessed great ambivalence in that commitment as Congress has alternately provided critically needed public funding for education in one legislative session, only to retract or shrink educational funding in the next session.

A primary example of this ambivalence is seen in the United States Tax Code -- specifically Section 127 which provides support for education through an exclusion from income for employee educational assistance. Section 127 has been repeatedly allowed to expire and then re-extended. It last expired on December 31, 1987. The tax bill recently approved by the Ways and Means Committee (H.R. 4333) reenacts Section 127, but in a severely diminished form.

The intent of Section 127 is to encourage employees to further their education, to allow employers to develop a more competitive workforce, and to create closer interaction between colleges, universities, business, industry and their communities. Employees, private and public industry, and educational institutions all derive substantial benefits.*/

This tax provision benefits the educational community in several ways. First, employer-provided assistance encourages colleges and universities to design programs to fit the needs of regional employers and their employees. In this period of decreasing numbers of traditional-aged college attendees, the increase in local and part-time enrollment attributable to employer-provided education has strengthened many educational institutions. Second, many colleges and universities developed educational assistance programs under Section 127 as a benefit for their own employees. Higher education recognizes the importance and value of advanced degrees and Section 127 offers a needed inducement to staff at all levels. Third, colleges and universities provide outstanding graduate students with non-cash financial assistance by waiving tuition fees which makes it possible for many excellent students to complete graduate studies. Section 127 provides that this non-cash fringe benefit may be excluded from income.**/

We wholeheartedly support the extension of Section 127. However, we deplore the destructive amendments to that section approved by the Ways and Means Committee in H.R. 4333. Under prior law, the exclusion was available for up to $5,250 of educational assistance during a calendar year. It applied to graduate as well as undergraduate education. Under the Ways and Means Committee bill, the prior-law limitation of $5,250 would be decreased to $1,500 and would not apply to programs leading to a graduate degree, except for graduate teaching or research assistants. These two modifications -- the limitation of the exclusion to undergraduate education and the cap of $1,500 -- substantially reduce the enhancement of educational opportunity of Section 127.

In view of current tuition costs at many educational institutions, the $1,500 cap will make the exclusion almost worthless for many employees. Moreover, employers' aversion to assuming the administrative burdens of withholding on benefits in excess of the $1,500 cap may prompt some to reduce educational assistance to that amount which is excludable under the tax laws. Thus, workers face not only the prospect of increased taxes, but also a possible loss or reduction of benefits. Saddling Section 127 with a cap of $1,500 per year will also deplete its utility to most graduate research and teaching assistants.

The restriction of Section 127 benefits to undergraduate programs will prevent even lower- and middle-income employees from excluding tuition assistance for advanced training beyond the bachelor's degree. This arbitrary limitation fails to recognize that in many fields, education beyond the bachelor's degree is key to vocational and professional advancement. Failure to provide the proper incentives for advanced level training could have a potentially devastating impact on the nation's supply of the types of skilled professionals. Ultimately, we may witness a decline in the critical specialty areas which this country will need to ensure its competitiveness into the future.

Concern about international competitiveness has surfaced repeatedly in this Congress. In a letter dated June 22, 1988, the Congressional Competitiveness Caucus, chaired by Senators Max Baucus and John Chaffee and Representatives Buddy MacKay and Claudine Schneider, urged the Chairman of the Senate Finance Committee to support the reenactment of Section 127:

> It is critical to the international competitiveness of U.S. business that Congress act to create an environment that encourages productivity improvements in the workplace. One way of doing that is to encourage business to offer employees the educational opportunities to keep up with the changes in the workplace caused by technological advances. We believe that Section 127 has encouraged businesses to do just that. We also believe that the exclusion is very important to the future international competitiveness of U.S. businesses.

We believe that America's future depends on the unfettered continuation of a strong partnership between our government, industry, and educational institutions. Section 127 is an essential component in that equation. It should be reenacted without destructive amendments crafted primarily to offset the negative revenue impact of other tax provisions.

---

*/ Over the past nine years, more than seven million workers have used Section 127 assistance to upgrade their skills and to keep themselves, and their companies, competitive in technological and industrial development.

**/ Colleges and universities have traditionally offered outstanding graduate students a package of financial assistance, consisting of both cash stipends for teaching and/or research, and tuition waivers. Under current law, all amounts that represent compensation for services are subject to tax.

Bank Building
Corporation

3630 S. Geyer Road / P.O. Box 8529-A / St. Louis, Missouri 63127 / (314) 821-2265

July 19, 1988

Ms. Laura Wilcox
Hearing Administrtor
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this leter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We are opposed to the provisions of S.2078 which would require employee approval for establishment of an Employee Stock Ownership Plan for the following reasons:

1. It would interfere with free market activities.

    Employers develop employee benefit plans, including Employee Stock Ownership Plans, as a part of a total compensation plan to attract and retain employees in a competitive market place. Passage of this legislation would needlessly limit employers' flexibility in designing comprehensive compensation plans.

2. It would impose a form of collective bargaining on all employers and employees under specific circumstances where collective bargaining is not otherwise utilized.

3. Current legislation and regulations are sufficient to protect employees when Employee Stock Ownership Plans are enacted.

    In many instances, Employee Stock Ownership Plans are additions to the total compensation package. There is surely no need to obtain prior employee approval for an increase in benefits.

    When an Employee Stock Ownership Plan is a replacement for another benefit plan and assets are being transferred from a prior plan, existing regulations protect against unreasonable utilization of the prior plan's assets.

Sincerely,

Myron Carpenter

Myron Carpenter
Senior Vice President and
Chief Financial Officer

MAC/rh

Bank Building & Equipment Corporation of America

Benefit Concepts, Inc.

July 13, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Benefit Concepts Financial Services, involved in the design, installation and administration of ESOP's, most strongly objects to the proposed bill and amendment for the following reasons:

> The premise of an employee stock ownership plan is to permit the employer, major stockholders, board of directors and controlling interest of the company to make a decision about their company, it's future, and stockholders. This process does not need employee approval.
>
> There are adequate protections for employees under state and federal laws to prohibit the abuses of an ESOP without the proposed regulations and amendments.
>
> To adequately inform employees would also require the employer and controlling interest to provide employees with information that is unrealistic, unnecessary and out of compatibility with the operations of the business and of no right to the employee under any circumstances.
>
> To provide the employees with this kind of control and information prior to their stockholder involvement in the company and before they have risks or economic involvement in the decision, is unacceptable. The proposed law would destroy any possible use of an ESOP as a planning tool in the future.
>
> To have employees approve a plan without full disclosure of all economic, political and other factors involving the formation of an ESOP, would be as unconscionable as asking the employee to run the company by committee. The proposed bill creates the total destruction of the formation of an ESOP.
>
> It should be noted that ESOP's have just begun to work for the closely held private sector, as the comfort level of all the participating members of an ESOP has reached an acceptable level. Design, installation, communication and administration have utilized the advantages for both the stockholder and the employees. There must be a "win - win" to all participants in an ESOP or it will not continue. ESOP's are the opportunity to distribute the assets and capital growth, capital accumulation and opportunities of this country's vast privately held business without this unneeded inclusion or amendments into the process.

Ten Governor Park

Sincerely,

Ronald H. Windemuller, CLU
Executive Vice President

RHW:la

BRANHAM
733 THIRD AVENUE
NEW YORK, N. Y. 10017

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, D.C. 20510

July 14, 1988

RE: STATEMENT FOR COMMITTEE'S JULY 12 HEARING RECORD ON S.2078, TO REQUIRE A MAJORITY OF EMPLOYEES TO APPROVE THE ESTABLISHMENT OF AN ESOP.

Dear Ms. Wilcox:

I am enclosing this letter and four copies for inclusion in the Committee's printed record of the July 12, 1988 hearings on S.2078, (Committee Press Release H-28). As the Chairman of an ESOP formed in 1980, I'd like to express my opinion that the Senate Bill 2078, which I understand would require the majority of employees to approve the establishment of an ESOP would be unduly restrictive and would ultimately hamper the growth of ESOPs in the United States.

S.2078 would place an unjust burden on the management group that would wish to restructure an existing corporation as an ESOP, because the concept of an ESOP is still generally unknown to American workers.

I believe that people are reticent to accept any change in their working environment and without extensive education as to the benefits of an ESOP concept, they would naturally vote to reject it since it would represent unknown change to them.

I would like to believe that enlightened managements elect to establish ESOPs for their employees because they wish to share their businesses with these employees and help the employees grow to manage the companies for themselves. It is a movement that leads to true work place democracy with total participation by all employees in sharing the rewards of their profitable endeavors.

However, it is an ongoing educational requirement that the benefits of ESOPs be taught to all employees. Such a goal is seldom achieved through one mailing or one meeting.

I'm afraid that the Armstrong Bill would stifle the formation of ESOPs because few companies would embark upon the educational process before soliciting a vote.

Pass through voting rights is a far greater benefit that the employees deserve to receive and I would be far happier to support legislation which would bring about the concept of employees voting their shares three years after the establishment of any ESOP. That would make far more sense to me.

Sincerely,

Joe Lafferty

C. D. J. Lafferty

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, D.C. 20510

BDS
Benefit Design Services, Inc.
847 James St., Syracuse, NY 13203 (315) 472-5537

July 13, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

The long term result of this proposed legislation will surely be that fewer employees have the opportunity to share in the success of the companies in which they work. The millions of Americans who may otherwise not have the opportunity to participate in owning capital, will surely lose that opportunity if this legislation is passed.

Has it been forgotten that ESOPs provide beneficial ownership? If new rules and regimentation as proposed in this bill are approved, you will have succeeded in changing a win-win situation into a lose-lose situation. If a major objective is to assure employees that they will not lose present benefits, then propose a bill stating exactly that. Otherwise, pass this bill, and you will be taking the first step toward extinguishing future hopes of the best opportunity in history for American workers to participate in capitalism!

Sincerely,

S. Joan Duncan
Vice President

SJD/rk
cc: Mr. Ed Mihalski
Minority Chief of Staff
US Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

CallCenter
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Data Processing
302 Knickerbocker Road
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Robert J. Rudolph
President
(201) 567-5316

July 22, 1988

Ms Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, D.C. 20510

RE: STATEMENT FOR COMMITTEE'S JULY 12, 1988 HEARING RECORD ON S.2078, TO REQUIRE A MAJORITY OF EMPLOYEES TO APPROVE THE ESTABLISHMENT OF AN ESOP.

Dear Ms Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We at CallCenter Services, a leading telemarketing company in Cresskill, New Jersey, wish to express our strong opposition to the Armstrong ESOP bill (S.2078). We do not agree with the introduction of massive government regulations regarding the establishment of ESOP's at privately held companies such as ours.

We trust that by communicating this opposition to you, our voice will be heard and this bill will be defeated.

Sincerely,

Robert J. Rudolph
President

RJR:lp

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, D.C. 20510
Five (5) copies

Carter Myers
& Associates

P.O. Box 656 Chester, Virginia 23831 (804) 748-8295

July 18, 1988

Ms. Laura Wilcox
Hearing Administrator
U. S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Comittee printed record of the July 12, 1988 hearings.

We are "against" S.2078 which would require a majority of employees to approve the establishment of an ESOP. Please consider my view for the hearing record.

Sincerely,

H. Carter Myers, III
Chief Executive Officer

CC: Mr. Ed Mihalski
Minority Chief of Staff
U. S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

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Brooklyn Park Mn. 55428
(612) 425-7474

July 18, 1988

Ms Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms Wilcox;

Pursuant to the Committee's request for testimony of S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Clutch & U-Joint Brooklyn Park Inc., opposes the enactment of S.2078 because of the additional record keeping that would be required under this legislation.

Sincerely,
Clutch & U-Joint
Brooklyn Park Inc.

Gregory S. Jude

Gregory S. Jude
Treasurer

cc; Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

COLUMBIA
FOREST
PRODUCTS, INC.
2020 S.W. 4TH / SUITE 520 / PORTLAND, OREGON 97201 / 503-224-5300

July 12, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We strongly oppose the ESOP provisions as set forth in proposed S.2078. We are a successful ESOP company with 1,200 employees enjoying the benefits and realization of appreciated value associated with stock ownership. We feel that the provisions in S.2078 would severely inhibit the opportunity for the establishment of new ESOP's and create huge and unnecessary Government regulations and cost.

Sincerely,

COLUMBIA FOREST PRODUCTS, INC.

BG Moore
Bruce G. Moore
Corporate Personnel Director

BGM:kam
enclosures
c.c. - Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
(5 copies)

CIGNA Individual Financial Services Company
a CIGNA company

3010 East Camelback Road, Suite 200
Phoenix, AZ 85016
(602) 956-6330

CIGNA

July 11, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Dear Mrs. Wilcox:

I beg you to please not allow the ESOP structure to be compromised by allowing in any way Senator Armstrong's idea of requiring an employee vote approving the establishment of any ESOP. I am convinced that ESOP is the most significant opportunity to broaden the capital base of our economy and ultimately result in significant increased tax revenues while enhancing productivity, morale and pride of ownership. As a representative of The Arizona ESOP Group and The CIGNA Corporation we are adamantly opposed to any requirement that employers be deterred in any way from consideration of implementation of an ESOP plan by requiring employee approval. The psychological impediment will clearly present an obstacle to the additional formation of ESOPs where a severe need in the opposite direction is clearly needed.

Sincerely yours,

Frank Amato

Frank A. Amato, ChFC, CLU
Registered NASD

An Employee Owned Corporation
ComSonics,® Inc.
1350 Port Republic Road
P.O. Box 1106 Harrisonburg, VA 22801
(703) 434-5965

RESEARCH DEVELOPMENT TECHNICAL SERVICES COMMUNICATIONS CATV CCTV ACOUSTICS

July 14, 1988

Ms. Laura Wilcox
Hearing Administrator
U. S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

From an original one owner stockholder company established in 1972, ComSonics, Inc.converted to an ESOP in 1975 and has evolved to a 100% employee stock ownership firm .

I can truthfully say that we have experienced virtually all of the ESOP problems along the way, and have solved all of them to become a highly successful firm, becoming one of the Inc. 500 most rapidly growing firms in the country.

One of the greatest disappointments concerning the ESOP occurred in the first year of the Trust. Noting no improvement in morale or productivity after placing 18% of the corporation's stock in trust for the employees I found that, much to my horror, virtually all employees did not understand stock ownership, and further, many of those who did understand stock, regarded such ownership with suspicion. The problem lay not in our employees, but in the education system which does not teach our children the real basis for wealth, i.e., a concept of equity ownership.

Undaunted, I pushed ahead with a consultant to train our employees to understand finance, and stock ownership, and the benefits of the same. After spending better than a third of a million dollars on a variety of training, the employees have become enthusiastic about employee stock ownership. They have become highly successful along the way, now sharing with each other 100% ownership of the firm. Further, their productivity has risen sharply, with the result that the stock value has risen 1130% over the past 12 years, topped by a 63% increase in the most recent fiscal year.

Now we come to the crux of the matter. Those same employees who are so enthusiastic about the ESOP today would, I believe, have voted the ESOP down during the first year of the ESOP plan. Please don't put that kind of decision into the hands of naive workers untrained in capital stock matters until we have provided the basis for a clear understanding of our American enterprise system in our public schools.

Our Employee Advisory Committee would echo the same sentiment today I am sure. Don't deny employees the opportunity to enrich themselves by placing such a complex decision in their hands. Currently the majority of employees not in an ESOP would not understand what it can mean to them.

I extend a special invitation for all members of the Committee to visit us at their pleasure. Since we are only 130 miles from Washington, DC by interstate, this should be feasible at some point and time. I assure you a most enlightening experience. By the way, I am the founder and currently serving in the position as chairman of the corporation at the desire of the employee/owners.

Best regards.

Sincerely yours,

Warren Braun

Dr. Warren L. Braun
Chairman and CEO

COBRO.

July 14, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

COBRO, as a successful employee owned Company, opposes the subject Senate bill because we think the bill would create massive Government regulations that would impede the creation of capital ownership for employees.

Sincerely,

James J. Durney
President and
Chief Executive Officer

JJD/dtt

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

CL Church Landscape Co. Inc. 951 N. RIDGE, LOMBARD, IL 60148 629-9660
Since 1963

July 12, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: **Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.**

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

As Secretary/Treasurer of Church Landscape Co., Inc., I would like to strongly express my opposition to Senator Armstrong's Bill S.2078.

We have had an E.S.O.P. for the past five years and our employees now own over 20% of the company.

The E.S.O.P. has helped us to more than double sales and triple profits since its inception. The team feels good about the company and about themselves.

Had the employees had to vote on this plan, this success may have not occurred. It is not that they would have voted the proposed E.S.O.P. down because of the risk. Basic lack of understanding of the E.S.O.P. may have forced them to vote emotionally and the E.S.O.P. may not have happened at Church Landscape.

Why not give other companies the chance allowed to us. Please testify against Senator Armstrong's Bill later this month.

Sincerely,

Bruce A. Church
Secretary/Treasurer

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) Copies

BAC/jkm

Landscape Management • Maintenance • Installation • Irrigation • Interiorscape

COLEMAN
&
COMPANY

July 14, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

I believe that enactment of the Armstrong Bill, as proposed, would seriously hamper the creation of new ESOPS. The Bill would unnecessarily complicate an already complicated process of implementation requiring the Secretary of Treasury to issue voting rights regulations resulting in massive government regulations and involvement in ESOPS.

ESOPS provide the best means available today for shared capital ownership and enhanced labor/management relations, both of which will lead to greater economic growth and job security. There are enough items of significance to deal with without tampering with a well-thought out and excellently drafted area of the law that does what it is supposed to do for the benefit of employers, business owners and employees alike.

I urge you to strongly recommend withdrawal and/or defeat of S.2078 and thank you now for your support of employee ownership and gain sharing.

Sincerely,

James L Moore

James L. Moore
Attorney at Law

JLM/ds

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

July 21, 1988

The COBRA Coalition

Senate Finance Committee
Statement for the Record
on
Health Care Continuation Rules

Introduction

The COBRA Coalition is pleased to submit for the record the statement below which details our position on the proposed legislative changes to the health care continuation rules embodied in the Consolidated Omnibus Budget Reconciliation Act ("COBRA"; P.L. 99-272). The COBRA Coalition represents a variety of interests including insurers, agents, HMOs, small business and health benefit plan administrators. As benefit providers, health plan administrators, plan service providers and employers we have an interest both in preserving the original Congressional intent of the COBRA health care continuation rules and in securing workable improvements to these rules.

Background

In 1986 as part of COBRA, Congress enacted certain health care continuation requirements for employer-provided health plans. In general, these rules require employers (of 20 or more employees) sponsoring group health coverage to offer a right to purchase continuation of that coverage to employees, their dependents and others ("qualified beneficiaries") who lose such coverage due to separation of service, divorce and other prescribed situations ("qualifying events"). The coverage so provided is known as COBRA continuation coverage; it must be offered for 18 or 36 months depending on the type of qualifying event. A qualified beneficiary may not be charged more than 102% of the applicable premium.

COBRA was correctly designed to impose on employers (rather than other persons) the health care continuation obligation described above owing to the fact that only the employer is in a position to attend to such responsibilities. Both the statute and the proposed Regulation spell out which plans must comply and when, who are qualified beneficiaries, what are qualifying events, the type and duration of such health care continuation coverage and how elections and payment for such coverage shall be made. In all such instances, the compliance burden is properly placed on the employer, the only reasonable source for the knowledge of or control over the items and events that demand attention under the law. The law itself directly makes this point: "the plan sponsor (employer) shall provide ... that each qualified beneficiary ... is entitled, under the plan to elect ... continuation coverage" (29 U.S.C. 1161(a)).

Since the responsibility for continuation coverage lies with the employer, it follows that the penalty also relate to the employer. Thus, under current law any employer who fails in its COBRA responsibilities will lose its deduction (IRC 162(i)) for the health plan and the employer's highly paid employees will lose their exclusion from income (IRC 106) for coverage provided by the plan.

Although COBRA is barely two years old and while the Regulations are still in proposed form, there have been calls from some quarters to amend the law. Responding to complaints about the penalty contained in COBRA, the House in 1987 approved amendments (as part of the Omnibus Budget Reconciliation Act of 1987; H.R.3545) designed to ease these penalty provisions. The House-approved proposal also included an extension of COBRA liability to other persons beyond the employer as well as making other changes to the health care continuation rules. However, these amendments failed to be enacted.

A similar effort to amend COBRA has carried over to 1988. Various adjustments to COBRA -- ranging from minor technical changes to more fundamental changes -- have surfaced in at least three current legislative proposals:

(1) H.R. 4333, The Miscellaneous Revenue Act of 1988;

(2) H.R. 4845, which makes certain pension and employee benefit-related technical corrections to the Tax Reform Act of 1986, the Omnibus Budget Reconciliation Act of 1986 and the Pension Protection Act of 1987; and

(3) H.R. 5080, which makes technical corrections to the health care continuation coverage rules of the Public Health Service Act.

COBRA Coalition Position

Thus far the given reason for most of these proposed changes (at least those that are more than just "technical") is that persons other than the employer (e.g., insurers, HMOs or third party administrators - TPAs; all of whom are members of the Coalition) are interfering with or hindering the employer's efforts to comply with COBRA. In particular, the most common complaint has been that such other persons are refusing to provide continuation coverage to qualified beneficiaries. A secondary complaint is that such other persons are not attending to their administrative duties under COBRA.

We believe that such claims are unfounded which has led to our general view that many of the changes embodied in the proposals noted above are not needed. However, we also believe that there are certain aspects of COBRA that do indeed deserve the attention of Congress and should be the subject of legislative change in 1988. These truly technical changes would provide all parties (employers, benefit and service providers and beneficiaries) with a better understanding of their obligations, responsibilities and liability under the law ... resulting in both better compliance with COBRA and more consistent coverage for beneficiaries.

We have detailed below our position based on issue areas rather than on specific pieces of legislation related to COBRA. This approach is particularly appropriate given the uncertainty of which bill contains which issue and in what form. We hope that this approach will provide the Committee with both a fuller understanding of our views and the background needed to improve the health care continuation rules of COBRA.

To the extent our position on the issues is found acceptable to the Committee, we respectfully request that appropriate legislative history be adopted to provide the needed guidance to the regulation writers and others. It is particularly important to us that our position on the various issues not be read out of context; consequently, if a position is adopted the legislative history should reflect the qualifiers we have provided attendant to a given issue.

1. Imposition of Liability under COBRA

Joint and Several Liability

While we support the extension of tax liability to persons other than the employer under the specified circumstances noted below, we are quite opposed to the imposition of joint and several liability on non-employers for failures arising in connection with the provision of benefits or services under COBRA.

In enacting the health care continuation rules under COBRA, Congress correctly made employers accountable for any violations inasmuch as employers alone have the information, knowledge, access to and control of records necessary to attend to COBRA responsibilities. The very essence of COBRA -- identifying "qualifying events" and providing coverage -- relates to circumstances about which only the employer and the employee have knowledge and control. Since most compliance failures involve an employer's failure to extend an offer for continuation coverage upon the occurrence of such a qualifying event, it would be inappropriate to hold other persons jointly and severally liable for something over which they have no control.

Moreover, such other persons should not be held responsible for the possible noncompliance of someone else, i.e., the employer. Such other persons have no way of "policing" the employer's compliance as they have no right to interject into the management of the employer's plan. Furthermore, in those instances where such other person has contributed in whole or in part to the compliance violation, the employer currently has a legally enforceable right under state contract law to recoup any penalties imposed from such other person. In addition, many state insurance codes already provide an additional avenue of relief. And of course with the proposed extension of liability changes noted below, the true failures of other persons will in fact result in the imposition of a penalty on such other persons.

Thus, we support maintaining the group health plan sponsor (the employer) as primarily liable for any excise tax imposed for a failure under COBRA; however, we also support extending such tax liability to other persons to the extent that such other persons' act or failure to act resulted in a violation of COBRA in the situations described below.

Limited Extension of Liability

As noted above, we support retention of the employer as the principal entity responsible for COBRA and COBRA compliance. This is the original design of COBRA and reflects the intent of Congress.

However, we also support the notion that other persons beyond the employer should have liability under the law within certain limited circumstances. Thus, we support an extension of liability to such other persons for specific failures under COBRA in situations under the control of or the responsibility of someone other than the employer such as an insurer, an HMO, a TPA, etc.

To be specific, we believe that in addition to the employer such other persons should have liability for a portion of the excise tax under COBRA (assuming the current excise tax proposal survives; see item 2 below) to the extent such other person's action or inaction caused the plan to fail under COBRA. Since COBRA compliance can generally be divided into two broad areas, we support the extension of excise tax liability to non-employers as noted below.

Continuation coverage - If any "problem" under COBRA deserves attention, it is this aspect of the law, i.e., assuring the availability of continuation coverage to a qualified beneficiary. Providing continuation coverage is the heart of the law; therefore, we would support the establishment of excise tax liability for a benefit provider who refuses to make such coverage available in two related circumstances. First, where such other person providing benefits under the plan refuses to make continuation coverage available to a qualified beneficiary despite timely and proper notification by the employer of the existence of a qualified beneficiary entitled to elect such coverage. Second, where such other person replaces the existing or previous provider of benefits and yet refuses to make continuation coverage available to an existing qualified beneficiary upon timely and proper notification as of the effective date of the plan.

By such a change the law would provide that the provider of benefits (such as an HMO or an insurer) would have to make continuation coverage available both to new qualified beneficiaries (in the case of an individual under an existing plan who obtains the status of a qualified beneficiary) and to existing qualified beneficiaries (in a situation where qualified beneficiaries exist under a plan and the provider proposes to replace the existing or previous provider of benefits).

Certain limitations would have to apply to this extension of tax liability beyond the employer. First, the employer must give timely and proper written notice requesting such continuation coverage. We suggest 60 days from a qualifying event or, in the case of a new provider of benefit coverage, prior to the effective date of such replacement coverage.

Second, this extension of liability for refusing to make continuation coverage available would not apply where the parties have agreed in writing to handle continuation coverage in a different manner. For example, in a replacement of benefit provider situation, the employer may prefer to cover existing qualified beneficiaries on a self-funded basis rather than through the replacing carrier (this may cost the employer less). A written agreement to this effect would take precedence over the employer's subsequent request that such coverage be provided by the replacing benefit provider.

Third, this change should not disrupt existing state law with respect to similar obligations already imposed on some benefit providers such as insurers. Under existing state Discontinuance and Replacement laws, in a carrier replacement situation an inter-related obligation is placed on both the prior and replacing carriers: an extension of benefits obligation falls on the prior insurance carrier while the replacing carrier must make sure that persons on claim are treated no less favorably than if the switch in carriers had not occurred. The design of this obligation is to guarantee that persons on claim are unaffected by the carrier change.

Thus, the COBRA continuation coverage change we support (to require continuation coverage upon the employer's written request) must recognize that the COBRA requirement shall apply only in the absence of a state requirement imposing a substantially similar requirement. Otherwise, an unintended conflict will surface. This contradiction cannot be resolved by a rule providing that the most stringent of two laws (federal and state) apply as the obligations cannot be quantified: They are placed on different entities as the prior carrier would have an obligation under state law while the new carrier would have an obligation under COBRA. However, under our proposal the end result is the same: the employer's written request that continuation coverage be made available will have to be honored in a manner which guarantees that persons affected by a change in carriers are not treated less favorably than if no change in carriers had occurred.

In short, our proposal would establish a tax liability for a benefit provider who refuses to make coverage available irrespective of when such person became a qualified beneficiary (i.e., whether while the plan is effect or in a benefit provider replacement situation).

This change should apply to benefit coverage only and not to administrative services provided under the plan inasmuch as the marketplace must dictate what, if any, services are provided by a given party. The law should not be used to prejudge whether the employer will perform its own COBRA services, allow the insurer (or other entity) to handle them or contract with a consultant outside the control of both.

In addition, it should be made clear that any change in the law in this area would not force the employer and any other person to negotiate, bargain or contract for the services or benefit coverage provided by such other person to the employer or otherwise interfere with the existing contractual rights of the parties with respect to such services or benefits.

If the employer fails to provide timely and proper written notice of the existence of a qualified beneficiary, the benefit provider should be allowed to adjust the quote or proposal based on the actual risk assumed, withdraw the proposal in a replacement situation or take other action allowed under law to remedy the situation.

Administrative compliance - The second general area appropriate for an extension of liability relates to administrative compliance responsibilities under COBRA. Under current law the responsibility (and therefore liability) for such requirements falls on the employer. However, often enough the employer will bargain with another party (such as an insurer, HMO, or TPA) for the performance of such duties. In other cases, the employer will assume this responsibility directly.

With respect to such administrative compliance requirements, we support a change in the law that would extend to persons other than the employer an excise tax liability resultant from a violation of a COBRA administrative compliance requirement provided such other person had accepted responsibility for the compliance requirement pursuant to a legally enforceable written agreement.

As an example, the administrative agreement for a health plan may provide that the employer is responsible for mailing required notices to eligible beneficiaries and that an insurance company is responsible for determining and collecting premiums. Assuming that the parties have agreed to this division of responsibility, the employer would be penalized for any failure relating to notices and the insurer would be penalized for any failure relating to premiums.

By this change the law would encourage the parties involved with a group health plan to allocate various responsibilities and attendant liabilities between or among themselves in writing; therefore, this change should be drafted in a manner that does not supplant or interfere with such written agreements between employers and other persons.

On the other hand, it would be inappropriate to assign liability for administrative compliance failures to other than the employer in situations where no duty exists or where the responsibility has not been knowingly assumed by such other entity pursuant to a legally enforceable written agreement. To assign such liability in the absence of a written agreement allocating administrative responsibility under COBRA is far too important to leave to chance: It would totally revise the structure and intent of COBRA well beyond the scope of "technical corrections." Furthermore, the result could be chaotic and a step backwards from the purpose of COBRA as insurers and consultants could become rather reluctant to provide benefits or services.

2. Penalty Provision

We support the switch from the current penalty (loss of deduction/loss of exclusion) to an excise tax form of penalty. We would agree that such an excise tax would be a more equitable approach and would enhance compliance and enforcement under COBRA.

We also believe that the sanction of such an excise tax must be balanced by some real world practicalities; consequently, we support the change to an excise tax form of penalty as qualified below:

- Inadvertent failures - The excise tax should not be imposed during a period of noncompliance if it can be established that the person liable for the tax did not know, or, exercising reasonable diligence, would not have known, that the failure existed;
- 30-day Grace Period - The excise tax should not apply to any failure due to reasonable cause and not willful neglect where such failure is corrected within the first 30 days of noncompliance;
- Waiver - For a failure due to reasonable cause and not to willful neglect, the secretary should be authorized to waive part or all of the excise tax to the extent such tax would be unreasonably burdensome to that person based upon the seriousness of the failure and the good faith efforts of that person to satisfy the health care continuation rules.

In any event, the amount of the fine to be imposed should bear a reasonable relationship to the failure involved such that the tax will serve as a true compliance enforcement mechanism rather than as a revenue-raising technique.

Because of the possibility of an extension of excise tax liability beyond the employer, we are concerned by the absence of an overall limitation on the amount of the excise tax to be paid by such other persons. All of the proposals we have seen propose an acceptable tax calculation methodology (so much a day per qualified beneficiary) plus a maximum liability limitation calculated by factors that relate solely to the employer (the lesser of a flat dollar amount or a percentage of the employer's yearly health plan costs). If liability for the COBRA excise tax is to be extended to persons other than the employer, it is our view that the tax applicable to such other persons should be similarly calculated with the addition of a provision establishing an appropriate cap for such non-employers.

The very extension of liability to such other persons in and of itself will make such non-employers much more mindful of their responsibilities and obligations under COBRA. Without an overall cap with respect to such non-employers, the unlimited exposure faced by such persons would increase (not decrease) the compliance problems with COBRA as non-employers would be that much more reluctant to offer or provide assistance to employers thereby depriving employers of counseling and other services traditionally performed by such other persons. Thus, Congress should avoid discouraging the involvement of such non-employers with respect to administrative services, the provision of benefits and consulting assistance by establishing an appropriate maximum liability for such other persons.

We therefore support the establishment of a maximum tax liability cap for such non-employers based upon a flat dollar amount only inasmuch as the percentage test factor used for employers simply does not "fit" when applied to non-employers. We believe that the flat dollar amount to be used should be the same as that adopted for employers. And please note that this proposed cap only applies to inadvertent failures, i.e., the excise tax imposed for willful neglect failures would not be so limited.

3. Payment Requirements

Under existing law the premium for COBRA coverage may not be collected until the passage of 45 days after a beneficiary's election for such coverage. Since this current provision could be read to prohibit an employer from ever charging any premium for any period of COBRA coverage prior to the 45th day, clarification of this provision is needed to make it clear that the 45 day rule only defers payment of premium and does not provide free coverage during this period.

A current (1988) proposal would further provide that the 45 day prohibition on the collection of premium applies to both coverage prior to an election (current law as noted above) and to any other period of continuation coverage (i.e., the period subsequent to the election).

Our objection to this proposal is based on two concerns. First, as noted above, it must be clear that this rule, if continued and extended, only operates to defer the payment of premium and does not prohibit the ultimate collection of premium for the period in question. Second, it must be recognized that during this 45 day period (or any other period where premiums have not been collected) the employer, the plan administrator or benefit provider may well be presented with claims incurred during the entire retroactive period for which no premiums have ever been paid.

Since it would be inappropriate and inconsistent with Congressional intent (to provide coverage at a reasonable cost to the beneficiary) to pay claims for which a premium has not been (or may never be) collected, we support a change in the law to offset such claims by any unpaid premiums. This could be accomplished by deducting unpaid premiums from benefit payments, suspending benefit payments or any other workable offset methodology depending on the facts and circumstances.

4. Independent Contractors

The current health care continuation rules define qualified beneficiaries to include certain "covered employees" and certain family members of covered employees all of whom obtained such status by virtue of the individual's employment or previous employment with an employer. A current proposal to change the law would broadly expand this definition to sweep in any and all persons receiving or performing services other than in an employer-employee relationship as provided by current law.

We are opposed to this change as proposed because it is overly and unnecessarily broad and would sweep into COBRA many individuals who would not otherwise be a participant in such a plan.

To the extent Congress feels the need to broaden this definition, such a change should provide coverage only to those independent contractors legally treated as employees and for whom a group health plan is being maintained by the employer. To do otherwise would place significant hardship on employers and make compliance infinitely more difficult inasmuch as typical employment related paperwork and tax withholding are not maintained for such individuals.

In any event, any such change should clearly note no intention to alter or change in any manner the current statutory and common law relationship between the employer and such individuals. Nor should any such change carry any implication with respect to such individuals' status as employees for any other provision of law.

5. Duplicate Coverage

Under current law COBRA coverage is terminated when the qualified beneficiary becomes "covered under any other group health plan ... "(29 U.S.C,1162(2)(D)(i))). This has the potentiality of creating a problem with respect to coverage for pre-existing conditions. For example, qualified beneficiaries who lose COBRA continuation coverage (as a result of coverage under a new plan) may find that they are not covered at all for a specific condition because the new plan excludes such condition as a "pre-existing condition."

To respond to this problem a current proposal entirely drops the COBRA provision that terminates COBRA coverage when new coverage is obtained; consequently, under this proposal the individual could continue the COBRA coverage and enroll under the new plan. While this approach will respond to the pre-existing condition problem noted above, it creates another problem -- namely, which rules apply to determine which of the two plans pays for what and when. In short, in solving the pre-existing condition problem, the proposed change creates a duplicate coverage problem which needs to be addressed under COBRA to provide uniformity and consistency.

The result obtained from the proposal above (i.e., the presence of duplicate coverage) is not an uncommon situation for insurers and can adequately be handled through the application of state Coordination of Benefits (COB) laws and rules. Such state laws tell an insurer which plan is primary and which is secondary. However, the current National Association of Insurance Commissioners (NAIC) model that is followed in the states does not clearly spell out that the new coverage is primary over the COBRA coverage. Since it is clearly preferable for the new coverage to be primary over the COBRA continuation coverage (which we understand as well to be the position of employers), a change (initiated by Coalition members) to the COB provisions at the state level is currently underway at the NAIC to reach preferred result, i.e., to provide that the COBRA coverage is secondary in insured plan situations.

However, such is not the case with respect to non-insurers providing benefits under a group health plan; they too deserve uniform and consistent guidance as to handling the duplicate coverage situation that will result from the proposed change first noted above. We suggest an amendment to COBRA to incorporate by reference the needed provisions of the NAIC model group Coordination of Benefits regulation, as amended, so that such non-insurers may adopt such provisions as needed in order to attend to this duplicate coverage problem.

To this end we suggest the following language be added to Clause (iv) of Section 162(k)(2)(B) of the 1986 Code (and elsewhere as appropriate):

> "For purposes of duplicate coverages resulting from an election of continuation coverage by a qualified beneficiary, a group health plan may utilize provisions consistent with the model coordination of benefits provisions established and adopted by the National Association of Insurance Commissioners, as amended."

Conclusion

We believe the position described above attends to the important issues surrounding COBRA in a reasonable and workable fashion. We further believe that our position -- particularly as it relates to a first-time extension of liability for non-employers -- should be recognized as a meaningful compromise inasmuch as the law now provides for sole and exclusive employer liability.

As members of the COBRA Coalition, the undersigned organizations believe the suggestions embodied in our position reflect the policy to be followed as the Committee considers improvements to the health care continuation rules of COBRA. We further believe that our position on the issues provides the widest framework for making improvements to the health care continuation rules without going beyond the boundaries of non-controversial and "clean" technical corrections.

We have enclosed suggested language to reflect our position on the liability issue, the most "technical" of the positions noted above. Our suggested language to respond to the duplicate coverage problem is contained in the body of this statement. We would welcome the opportunity to provide suggested language for any other issue as appropriate.

Representatives of the COBRA Coalition are available to respond to any questions or follow-up activity generated by this position statement. Such inquiries should be directed to William Fritts, Jr. (223-7797).

Sincerely,

American Council of Life Insurance
Blue Cross and Blue Shield Association
Group Health Association of America, Inc.
Health Insurance Association of America
Independent Insurance Agents of America
National Association of Casualty and Surety Agents
National Association of Life Companies
National Association of Life Underwriters
National Association of Professional Insurance Agents
Society of Professional Benefit Administrators

Duff & Phelps Inc. 55 EAST MONROE STREET · CHICAGO, ILLINOIS 60603 · (312) 263-2610 · TELEX 25-5165

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

July 14, 1988

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Duff & Phelps is a 100% ESOP owned company employing over 220 people in offices in Chicago, Cleveland, Los Angeles, and Washington, D.C. Our ESOP has been extremely successful in providing significant retirement benefits as well as increased employee motivation and participation.

We are concerned that the proposed legislation (S.2078) would effectively prevent other companies from taking advantage of this excellent opportunity to provide a valuable employee benefit. The bill would do this because:

1) The time required to effectively communicate the complex nature of the ESOP to employees and take a fair vote would prevent ESOPs from being a timely alternative to a third party buyer. This is not only true in big corporate takeover situations, but also in cases where the owner of a small to medium size private business is considering sale of the company.

2) No other employee benefit (pension plan, medical plan, etc.) requires employee approval. As a result, an employer will be deterred from using an ESOP relative to these other plans because of the cost and disruption caused by the need to hold an employee election.

3) Many employees learn about the benefits of ESOPs and employee benefits only over time and after experience with the plan. Once employees become familiar with the plan, they can negotiate with employers to change or alter it. It is not uncommon for collective bargaining units to negotiate the specific terms of an ESOP, including voting rights, etc. This ongoing bargaining process should not be hampered by government regulations which place one set of standards on employers and employees with a wide variety of needs.

In summary, the proposed bill would seriously impair the creation of new ESOPs. This would violate the stated interest of Congress to promote employee ownership. This is why our firm strongly opposes the bill.

Very truly yours,

Chester A.

CAG:MJY

cc. Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
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Hart Senate Office Building
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PENSION PORTABILITY

AFTER TERMINATION OF EMPLOYMENT

Statement of
Emily S. Andrews, Ph.D.
Research Director
Employee Benefit Research Institute

What is Portability?

Portability involves the transfer of pension benefits from one pension plan to another. If all employees spend their entire careers working for only one employer, portability would not be an issue. All pensions would be based on full-career service. Similarly, if pensions were only paid through Social Security or some other nationwide plan, benefits would be fully portable between jobs, and all years of service would be credited by the plan. In our society, most employees change jobs and many employers supplement their employees' Social Security benefits through employer-sponsored plans.

In a pension system characterized by a diversity of benefits tailor-made to the specific industry, the company, and the work force, automatic pension credit transfers are difficult to attain. One employer may have a defined contribution plan and the other a defined benefit plan. Benefit and retirement provisions may vary considerably among plans, and plan contribution rates may differ as well.

The benefits of diversity in pension provisions include retirement practices that directly enhance the productivity of the company and that are appropriate to the financial status of the firm. In addition, differences in pension plan provisions can better meet the needs of different workers for their own retirement income. The cost of this diversity, however, is the relative benefit loss that may take place for employees who switch plans.

Types of Portability

While the basic concept of a fully portable pension is easy to understand, it is considerably more complex to categorize the ways in which our diversified system fails to meet full portability. To do so, the components of portability can be described in terms of: (1) vesting; (2) credited service; and (3) accrued current values (cash distributions). Current portability proposals only consider the first third components.

The 1986 Tax Reform Act (TRA) radically changed vesting standards for employees covered by single-employer, private-sector, defined benefit plans. Such changes, effective in plans years beginning after December 31, 1988 will essentially reduce the earlier Employee Retirement Income Security Act's (ERISA) 10-year vesting standard to a 5-year vesting provision. Through that legislation, more workers will be entitled to pensions upon job change.

When credited service is portable, years of service credited to one plan are maintained even upon job change. For instance, even if the employee has not met the vesting standard, years of participation would be carried over into the next employer's plan and would count toward the employee's pension on the next job. Multiemployer pension plans are often used to illustrate service portability. However, the recognition of the many problems involved in implementing service-credit portability has tempered active legislation in this area.

Portability of accrued current values (cash distributions) refers to the cash value of vested benefits. Distributions are portable when directly transferred to the employee leaving the sponsoring company or transferred directly to another retirement arrangement. The first situation is by far the most common.

Cash distributions are most often associated with distributions from defined contribution plans but may apply to certain defined benefit plans as well. Most defined contribution plans distribute vested benefits in the form of a cash lump-sum distribution, or "cash out" upon job change and at retirement. If preretirement cash outs are invested, the funds will continue to earn a market return until retirement, which, on average, would be roughly equivalent to what the employee would have received from the plan at retirement. A loss in retirement benefits occurs if the distribution from the plan is used for current expenditures rather than being saved and invested. This portability loss has been the focus of recent congressional interest. This testimony focuses on issues that relate to enhancing the portability of accrued current values.

The Issues Being Addressed

The Pension Portability Act (H.R. 1961) seeks to increase coverage and improve portability through a new type of retirement plan and through changes in Simplified Employee Pensions (SEPs). It also seeks to use pension rollovers to improve system portability and preserve benefits. Portability would be enhanced if preretirement distributions are saved until retirement, and if assets held until retirement are used for retirement income.

The 1986 Tax Reform Act (TRA) first sought to maintain preretirement distributions by imposing a 10-percent penalty tax on lump-sum distributions that were not rolled over into an IRA. It is too early to determine the extent to which this additional tax has achieved that goal. The Portable Pension Plan Act would allow preretirement lump-sum distributions if the penalty tax were paid but would require defined contribution plans to accept rollovers from other plans.

A second concern is to ensure that retirement benefits are available for retirement income. Just as preretirement distributions may be spent for current consumption at retirement, lump-sum retirement distributions may be spent early in retirement reducing retirement income in later vulnerable years. This concern dovetails the Retirement Equity Act of 1984 which requires that both spouses agree in writing to any benefit distributions in other than the joint and survivor form. Concern about the form of distribution was motivated by evidence that widows usually have significantly lower income than married couples. Recent concerns are also motivated by the knowledge that older retirees often have lower income than younger retirees.

Under the Pension Portability Act, joint and survivor distributions would be required for SEPs and portable pension plans. Annuity payments would be provided unless specifically waived by the participant and the participant's spouse.

Jobs and Job Tenure

The need for portability and preservation legislation is integrally related to the way the labor market functions. Benefits are more likely to be dissipated if workers change jobs many times over a career. American workers exhibit many patterns of lifetime labor force participation. Some individuals have held their job with the same company for their entire lifetime; in the future, others will to do the same. But many workers have many jobs. Women have more irregular careers than men and have shorter job tenure. Nevertheless, certain overall career patterns have important implications for portability.

Lifetime Employment

The reason many employees can expect to receive lump-sum distributions from prior jobs is because relatively few workers have lifetime employment. Many younger workers use their early years on the job for experimentation, changing jobs before they find a career that is, hopefully, both interesting and financially rewarding. Other workers make job changes later on to take advantage of new opportunities. And, of course, some individuals become unemployed or decide to leave the labor force for personal reasons. In a seminal study, Robert Hall used Census data to show that both men and women typically hold 10 or 11 jobs over a lifetime. By age 24, the average worker will have held the first four jobs out of a total of 10. The next 15 years will contribute another four jobs. Consequently most employees will not have vested in their plans during their early work years.

This hypothesis is reinforced by data on the proportions of wage and salary workers with five years or more on the job -- a rough proxy for vesting standards after tax reform. Only 7.3 percent of workers under age 25 had five or more years of tenure in 1983. This figure increased to 37 percent of those age 25 to 35 and continued increasing gradually so that over 75 percent of all nonfarm workers age 55 to 59 ended up with five or more years on the job. These figures demonstrate why many workers can count on pension benefits at retirement. They also suggest that many workers will accumulate pensions from more than one job. The issue is whether these benefits will be maintained until retirement.

Trends in Job Tenure

Some are interested in augmenting pension portability because of the perception that workers now change jobs more frequently than they used to. U.S. Census Bureau data do indicate that the average job tenure of working men fell between 1963 and 1987 from 5.7 years to 5.0 years. But almost all of this decline was a result of the changing age distribution of the work force. Among prime-age working men age 25 to 34, job tenure increased from 3.5 years in 1963 to 3.7 years in 1987. Tenure for men 35-44 averaged 7.6 years in both years. Men age 45 to 54 averaged 11.4 years on the job in 1963 and 12.3 years in 1987. Job tenure for women increased overall with gains particularly noticeable among women 35 years of age and older. Thus, observed declines in job tenure are entirely a result of changes in the distribution of workers by age and sex. Women have shorter tenure than men and younger workers have shorter tenure than older workers. In view of this evidence, portability may be of increasing concern due to changes in plan provision and societal expectations about retirement income but not because job stability has, on average, declined. Nonetheless, some, such as Pat Choat, suggest that changes taking place in the economy will require more flexible employment relationships in the future to maintain competitiveness. These arguments would predict that job tenure will be shorter in the future.

What Plans Are Provided?

Neither career patterns nor the provision of benefits operate within a static environment. Portability and preservation issues become more important as lump-sum distributions become more prevalent and are called upon to provide a greater fraction of retirement income. An expansion in the role of lump-sum distributions can stem from the greater prevalence of defined contribution plans and from greater asset accumulation within those plans. Lump-sum distributions could become a more common option in defined benefit plans. For the moment, the expansion of defined contribution plans seems the more significant trend.

More Defined Contribution Plans

The number of defined contribution plans has grown since 1974 from an estimated 245,000 in 1974 to 806,000 in 1986. Over 70 percent of all plans are defined contribution plans. Defined benefit plans actually account for the majority of plan participants, however, since many defined contribution plans are pension and profit sharing plans sponsored by small employers. Moreover, many participants in defined contribution plans also are in defined benefit plans.

The proportion of defined contribution plans has increased since the enactment of ERISA but not necessarily as a direct result of that legislation. Many believed that ERISA's changes -- including minimum funding standards and mandated insurance for defined benefit plans -- would result in a significant decrease in the number of defined benefit plans. Contrary to expectations, the absolute number of defined benefit plans has grown every year (expect 1976 and 1984). According to EBRI's plan-count statistics, defined benefit plans grew at an average annual rate of 5.6 percent between 1975 and 1986. But, as a proportion of all plans, the share of defined benefit plans fell 5.4 percentage points over the same period from 34.0 percent to 28.6 percent of all plans.

While the shift towards defined benefit plans has not been consistent in every year, other evidence suggests that it represents a long-run trend. Many employers have added defined contribution plans as secondary plans, and many employers are now restructuring their benefits to prepare for the baby boom's retirement. Employers have found that younger workers of baby boom age react favorably to defined contribution plans because they can see an immediate current cash value. In addition, employers realize that defined contribution plans are no longer simply an extra emolument. The benefit buildups are too great and the baby boom's retirement is too costly. Thus, defined contribution plans are becoming an integral part of retirement income planning. To the extent that cash distributions from these plans are spent before retirement, retirement benefits will be lost

The Assets in Defined Contribution Plans

Defined contribution plans represent an increasing portion of assets in all private trusteed pension funds. According to EBRI data from the *Quarterly Pension Investment Report* (QPIR), total assets in trusteed pension funds amounted to $1.2 billion by the end of the first quarter of 1988. Defined contribution plans held $410 billion of those assets or 34.4 percent of the total. Defined benefit plans accounted for 55.2 percent of trusted fund assets and multiemployer plans for 10.3 percent. The share held by defined contribution plans has increased considerably over the past five years from 29.9 percent of trusteed funds in 1982. Defined contribution plans are expected to continue to play an increasing role in financial markets.

The Prevalence of Lump-sum Distributions

While changes in job tenure and modifications in the structure of pension plans and plan provisions will substantially affect future benefit payments, lump-sum distributions at retirement and upon job change are extremely important even today. Information on current distributions provides baseline data to help understand the future.

Preretirement Distributions

Many workers have received or can expect to receive preretirement distributions. In 1983, some 6.6 million workers said that they had received a distribution from their pension plan. Close to 85 percent were for amounts of less than $5,000. How these preretirement cashouts were used depended on the dollar amount of the distribution. Only 26 percent of persons receiving preretirement distributions worth less than $5,000 used some for savings. Over half of all persons receiving cash outs in the $5,000 to $9,999 range, spent, rather than saved, some or all of the distribution. Thus, a substantial proportion of benefits provided by employer-sponsored plans before retirement are never translated into retirement income. Furthermore, among workers who met ERISA standards for plan participation in 1983, 21 percent of those entitled to current vested benefits and 57 percent of those entitled to past vested benefits, report those benefits were received or could be received as a lump-sum distribution.

Distributions at Retirement

Current retirees are less likely to have received lump-sum distributions than future retirees. Defined contribution plans were less prevalent than they are today (or are likely to be in the future). Most retirees received pension benefits in the form of an annuity. And many employers regarded defined contribution plans as savings plans not as an integral part of retirement income security. Nonetheless, even among workers retiring in 1982, lump-sum distributions at retirement were quite common. Among those retirees, nearly 10 percent of all men with pension coverage from any job they worked on reported receiving a lump-sum distribution from the primary plan on their last job. The median value of that retirement distribution was $20,000. Another 4 percent of male beneficiaries covered by a pension plan received a lump-sum benefit from the primary plan on their longest job (other than their last job). The median value of that distribution was $10,000.

Potential Portability Losses

In order to determine potential benefit losses if benefits are spent rather than saved, a simulation model was used to construct examples of the economic consequences of pension portability. The following general assumptions were used to analyze cashouts from defined contribution plans. Workers were assumed to be first hired on a job with a pension at age 25 and work each year until age 65. Assets were assumed to grow at a rate of 7.5 percent. Illustrations were computed for four different workers.

For Different Workers

The typical four-job worker with pension coverage is entitled to substantial pension benefits at retirement. A clerical worker would receive $25,626 in benefits and a retail-trade professional $106,448. A production worker would accrue $52,907 and a professional in financial services would have $145,684 (all in 1987 dollars).

These sums would only be available at retirement if pension accruals from each of the three earlier jobs were maintained in the plan or rolled over into an IRA (or other employer plan) and saved. If the distributions were spent, the retirement income losses would be considerable. The clerical worker could lose $18,290 and the retail-trade professional could lose $75,740. The production worker in manufacturing could lose $37,031 and the financial professional could give up $103,462. Potential losses of over 70 percent of benefits represent a substantial fraction of retirement income for these illustrative workers.

For Small Distributions

Many early cash outs are for sums of less than $3,500. This represents the value of accrued benefits that employers can, at their discretion, distribute to employees who change jobs. All the cash outs calculated in the clerical worker example are less than $3,500. If a hypothetical employee received distributions of exactly $3,500 at each job change, and that sum were indexed for inflation, the total value of those cash outs at age 65 would be $21,254 (in 1987 dollars) under a 7.5 percent interest assumption. If the $3,500 figure were not indexed for inflation, the value of those $3,500 unindexed cash outs would still reach $15,766 (in 1987 dollars) by the time the person reached age 65. In other words, small cash outs would be worth a sizable percentage of, for instance, the full $25,633 cash value of pension benefits that a female clerical worker would receive at retirement. It would also represent a significant proportion of the $52,937 benefit (in 1987 dollars) accrued by a male production worker who held four jobs between ages 25 and 65.

Conclusions

We live in a world in which lump sum-distributions already go to many current workers and retirees. Most of these distributions are small and are spent upon receipt. Although job tenure has not become shorter, pension vesting standards have been reduced and more workers can expect to receive lump-sum distributions in the future. Current data indicate that defined contribution plans are becoming more important both in numbers and in the assets they command. Defined contribution plans are most likely to provide lump-sum distributions upon job change. These facts suggest that portability will be of increasing importance to tomorrow's retirees. But since the aim of pension policy is the delivery of benefits, projections of future retirement income can provide further insights.

Future Retirement Benefits

Earlier work has shown that today's retirees have income that is roughly equivalent to that of the rest of the population. Projections using a microsimulation model indicate that the baby boom can expect higher levels of retirement income than current retirees. Much of these income gains can be attributed to the increased receipt of benefits from employer-sponsored plans and from higher benefit amounts from those plans. But the total pension replacement rate in retirement – the ratio of pension and Social Security benefits to preretirement earnings – will have fallen from 49 percent for the current generation of retirees to 45 percent for the baby-boom cohort. These rates are based on the assumption that workers will spend their preretirement distributions just as they do today.

Better Benefits with Preservation

If portability legislation were enacted that ensured that preretirement distributions were saved until retirement, replacement rates would be higher. The gains would depend upon how portability was ensured, be it through voluntary incentives or mandatory rollovers. While no data are currently available on lump-sum distributions from secondary plans, a 1985 study conducted by the U.S. General Accounting Office suggested that savings plans could significantly raise replacement rates in retirement. That study presented calculations based on information from five different organizations. The study indicated that for employees who retire at age 65 with 20 years of credited service and a $20,000 salary, replacement rates are about 55 percent for those with no participation in a supplemental thrift plan, over 65 percent for those with 50-percent participation and 78 percent for those with a full 6-percent contribution to a supplemental plan. Thus, supplemental plans have the potential to replace preretirement earnings at rates in line with retirement income goals such as those put forward by the Carter Pension Commission.

Portability legislation, in part, intends to ensure that preretirement distributions are saved for retirement. Such rollovers frequently stem from distributions from secondary defined contribution plans. These supplements may have the potential to increase replacement rates beyond those currently forecast. On the one hand, little is known about the efficacy of further voluntary incentives. Voluntary incentives may not work. On the other hand, mandatory rollovers would preserve benefits until retirement but workers would lose the flexibility to use their funds for other purposes they determine to be in their best interests. Hence, Congress must decide whether the need for higher retirement income justifies restricting choice. That decision may, in turn, depend on the increasing prevalence of lump-sum payments and the future structure of the retirement and health care systems.

the esot group, inc. 3580 Wilshire Boulevard / Los Angeles, California 90010-2516 / (213) 384-1128
FAX (213) 387-6274

July 13, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Ms. Laura Wilcox,

In response to the Committee's request for testimony, I wish to register my opposition to Senate Bill S.2078, introduced by Senator William Armstrong (R-CO).

The Bill, if enacted, would thwart ESOPs, curtail Capital formation, business perpetuation, and the transfer of equity to employees.

It would be a giant step backward for employees who have never had the opportunity to own stock in the company for which they are devoting their working careers.

This is being sent in quintuplicate to be included in the Committee printed record of the July 12, 1988 hearings.

Very truly yours,

The ESOT Group, Inc.

Robert A. Frisch
Chairman/CEO

RAF/li
cc: Ed Milalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

EXECUTIVE FINANCIAL
SERVICES, INC.

July 11, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Executive Financial Services, Inc. sells financial services and products primarily to small, closely held businesses in Kentucky, Tennessee and Mississippi. We specialize in the design and administration of ESOPs, having implemented over a dozen ESOPs during the past two years. As an attorney specializing in this field, I have addressed numerous business and professional audiences regarding ESOPs and have had several articles published on the subject. Most recently, I spoke on ESOPs in Atlanta at an insurance industry conference attended by over 5,000 members from around the world.

Based on my experience with ESOPs, I think they are very beneficial both to business owners and, in the right situation, to the businesses' employees. I also have seen situations where ESOPs have hurt both owners and employees. While I support Congress' desire to discourage the use of ESOPs in the "wrong situation" and to avoid the use of ESOPs where employees would be harmed, I am strongly opposed to S. 2078 which would require a majority of employees to approve the establishment of an ESOP.

I feel that S. 2078 would have an irreparable chilling effect on the establishment of ESOPs because of the time and expense involved in compliance with its provisions. I feel that vigorous DOL enforcement of existing fiduciary standards would be a much more effective deterrent to ESOPs that harm employee-participants.

Sincerely,

Kelly O. Finnell, President

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

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July 21, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

The purpose of this letter is to register my opposition against the Armstrong ESOP Bill (S.2078). No other fringe benefit plan requires an employee's approval before being implemented. This is true regardless of whether the plan is a retirement plan or welfare benefit plan. The Armstrong Bill would create an exception to this general rule. If enacted, we believe the Armstrong bill would be harmful to the establishment of additional employee stock ownership plans which would restrict the broadening of capital ownership in this country.

Yours very truly,

FOSTER, SWIFT, COLLINS & COEY, P.C.

Stephen J. Lowney
Stephen J. Lowney

SJL:kab
Enclosure
cc w/encl.: Ed Mihalski, Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

Ask your Neighbor about...
Ask your Neighbor about...
FRED SCHMID
APPLIANCES ▪ ELECTRONICS

William M. Golden
Vice President and Chief Financial Officer

July 22, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishement of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are being sent so they can be included in the Committee printed record of the July 12, 1988 hearings.

The Fred Schmid Appliance & TV Co., 2405 West 5th Avenue, Denver, Colorado 80204, an employee-owned company, wishes to convey opposition to the proposed legislation of S.2078. We feel the bill could severely hinder the formation of new ESOPs. Furthermore, we feel the bill is unclear as to the specific voting rights regulations which will be imposed by the Secretary of Treasury.

Your expression of our concerns are deeply appreciated.

Sincerely yours,

William M. Golden, Jr.
Vice President Finance and
Chief Financial Officer

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

WMG/jc

2405 West 5th Avenue, Denver, Colorado 80204, Phone (303) 620-8201

Statement for the Record of
Joseph F. Delfico, Senior Association Director
Human Resources Division

Before the
Finance Subcommittee on Taxation and
Debt Management
Committee on Finance
United States Senate

PENSION PORTABILITY AND PRESERVATION

SUMMARY

Pension portability refers to workers being able to transfer years of service or vested assets from one employer's pension plan to another. Pension preservation refers to assuring that workers who change pension plans conserve any cashed-out assets for retirement income rather than spending them for nonretirement purposes.

GAO examined three issues crucial to understanding pension portability and preservation for workers who are vested in pension benefits and learned the following.

1. How does job mobility affect workers' pension income in retirement? Compared to those who stay in one plan, workers who vest in a series of defined benefit plans could suffer retirement income losses. Their pension benefits under each plan are frozen at the time they separate and will not reflect salary growth between the time they leave the plan and the time they retire. In contrast, workers in a series of defined contribution plans will not experience a job mobility loss if their vested pension assets remain in the plans or are rolled over into an Individual Retirement Account (IRA) or a subsequent plan.
2. What kind of portability and preservation arrangements currently exist? Portability of service and pension assets in the private pension system is limited. Employees can preserve cashed-out pension assets for retirement by transferring them to IRAs or, in a few cases, another employer's plan. Many employees, however, have spent rather than preserved their cashed-out pension assets when changing jobs.
3. What problems and tradeoffs are involved in implementing proposals to enhance the portability and/or preservation of pension benefits? Current legislative proposals address pension preservation primarily by building on the concept of the rollover IRA; some such proposals could increase the administrative burdens of plans. Some options for maintaining the purchasing power of mobile workers' pensions from defined benefit plans have substantial drawbacks they would significantly increase employers' costs and remove some of the advantages these plans have for personnel management. Employers could react

> by switching from defined benefit to defined contribution plans, but this is a riskier way for workers to obtain adequate retirement incomes.

Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to summarize our review of pension portability and preservation issues for the hearing record. Pension portability refers to workers being able to transfer years of service or vested assets from one employer's pension plan to another. Pension preservation refers to assuring that workers who change pension plans conserve any cashed-out assets for retirement income rather than spending them for nonretirement purposes. Several legislative proposals currently being considered address various aspects of these issues.

Portability and preservation issues are of long-standing concern to the Congress and others. For example, the 1965 report of the President's Committee on Corporate Pension Funds and Private Retirement and Welfare Programs advocated, among other things, the establishment of a central clearinghouse to manage employees' cashed-out pension assets. A similar proposal was included in the Senate-passed version of the legislation that became the Employee Retirement Income Security Act of 1974 (ERISA). Other proposals have been debated, considered, and studied since the passage of ERISA. The fact that even today the discussions continue is evidence that while the issues are difficult to address, interest in them, particularly in the Congress, has not abated.

The primary motivation for portability and preservation proposals is the desire to promote adequate retirement incomes. The lack of pension portability may cause the retirement income of workers who change employers to be lower than if they had stayed with the same employer's plan for a full career even if they are fully vested in each employer's pension plan. In addition, research has shown that when job changers have been able to cash out vested pension assets, most have used the money for nonretirement purposes. To help preserve pensions for retirement income, provisions in the Tax Reform Act of 1986 were designed to provide a disincentive for using these funds for purposes other than retirement. The effectiveness of this legislation is not known yet. Continued use of cashed-out pension assets as in the past will clearly hinder the achievement of adequate retirement incomes.

At the request of the Subcommittee on Oversight, House Committee on Ways and Means, we reviewed recent studies and legislative proposals relating to pension portability and preservation for workers who are vested in pension benefits. In particular, we responded to three questions that are crucial to understanding these issues. Our findings can be summarized as follows:

1. How does job mobility affect workers' pension income in retirement? Compared to those who stay in one plan, workers who vest in a series of defined benefit plans could suffer retirement income losses. Their pension benefits under each plan are frozen at the time they separate and will not reflect salary growth between the time they leave the plan and the time they retire. In contrast, workers in a series of defined contribution plans who are vested when they leave their employer's plan will not experience a job mobility loss if their pension assets remain in the plans or are rolled over into an Individual Retirement Account (IRA) or a subsequent plan.

2. What kind of portability and preservation arrangements currently exist? Portability of service and pension assets is limited, with the exception of the social security system. Employees can preserve cashed-out pension assets (apart from previously taxed employee contributions) for retirement by transferring them to IRAs or, in a few cases, another employer's plan. Such assets then can continue to grow on a tax-deferred basis. Many employees, however, have spent rather than preserved their cashed-out pension assets when changing jobs.

3. What problems and tradeoffs are involved in implementing proposals to enhance the portability and/or preservation of pension benefits? Current legislative proposals address pension preservation primarily by building on the concept of the rollover IRA; some such proposals could increase plans' administrative burdens. Some of the options that analysts advocate for maintaining the purchasing power of mobile workers' pensions from defined benefit plans, such as indexing deferred benefits, have substantial drawbacks. They would significantly increase employers' costs and administrative burdens and remove some of the advantages these plans have for personnel management. Employers could react by switching from defined benefit to defined contribution plans, but this is a riskier way for workers to obtain adequate retirement incomes.

JOB MOBILITY MAY REDUCE WORKERS' PENSION INCOME

To become legally entitled to pension benefits (vested), workers must meet a plan's eligibility requirements and then remain in the plan a specified length of time. Because the Tax Reform Act of 1986 shortened the vesting timetables (e.g., from 10 years to 5 years), more workers are likely to have vested benefits in the future. Our testimony today and the pension portability and preservation proposals we reviewed relate only to workers with vested pension benefits.

Pension plans fall into two categories--those with defined benefits and those with defined contributions. Of all active plan participants in 1980, 60 percent (about 30 million) were in only a defined benefit plan, 26 percent (about 13 million) were in a defined benefit plan and at least one supplemental defined contribution plan, and 14 percent (about 7 million) participated only in a defined contribution plan.

Defined Benefit Plans

A defined benefit plan uses a specific formula to compute workers' pension benefits. According to 1984-87 pension data, about 69 percent of single-employer defined benefit plan participants belonged to plans that used "final-pay" formulas, which base benefits in part on salary immediately before retirement. For instance, the pension might be defined as one percent of "high-five" pay (the average of the highest 5 years of salary) times years of service. Other defined benefit plans base benefits on career average salary or pay a flat dollar amount per year of service (the latter is typically used by union plans for workers whose salaries are similar to one another).

Defined benefit plans help plan sponsors achieve various personnel management goals:

1. Because benefits accrue slowly during the early years of participation (compared with defined contribution

plans), employers can offset higher training costs for newer employees with relatively low pension contributions.

2. The benefit formula encourages workers to remain with an employer during their prime productivity years.

3. The employer can use special formulas to encourage older workers to take early retirement.

4. When employers set up plans, workers can receive past service credit so that their pension benefits reflect all years of service with the employer.

From the worker's point of view, defined benefit plans provide predictable benefits that typically are tied to earnings immediately before retirement. Further, such plans put the risk of investment performance on the employer, not the employee. That is, if the investment return on pension assets is not sufficient to meet benefit liabilities, plan sponsors are required to make up the difference with increased employer contributions. Even if sponsoring companies go bankrupt without sufficient assets to meet their pension liabilities, some percentage of the employee's vested benefit is generally guaranteed by the Pension Benefit Guaranty Corporation (PBGC). On the other hand, as described below, workers with vested benefits who leave a series of defined benefit plans before retirement will usually receive less pension income than workers who stay in a plan until their retirement age.

Defined Contribution Plans

In contrast to a defined benefit plan, the pension benefit from a defined contribution plan is based on the amount accumulated in the participant's individual account, not on a predetermined formula. In many types of defined contribution plans, the employer annually makes a specific contribution to each participant's account; for instance, 10 percent of pay or a percentage of the employer's profits. Each account also is credited with its share of investment return, including any increases or decreases in the market value of the underlying assets. In some plans, participants also receive a pro rata share of contributions made on behalf of employees who separate before they are vested; these funds are known as forfeitures. The pension at retirement or termination of employment may be paid in a lump sum, a life annuity, or a series of installments until the account is exhausted.

From the employer's standpoint, defined contribution plans offer the advantages of administrative simplicity and less regulation. From the worker's point of view, compared to a defined benefit plan, the value of defined contribution plan assets builds at a faster rate during the early years of a worker's participation, but slower during later years. Second, the vesting schedules are usually shorter. Third, as described below, workers' benefits are not generally affected by changing employers. On the other hand, the employee bears the risk associated with the investment performance of the pension assets; thus, there is no guarantee of a set relationship between salaries earned immediately before retirement and the pension benefit.

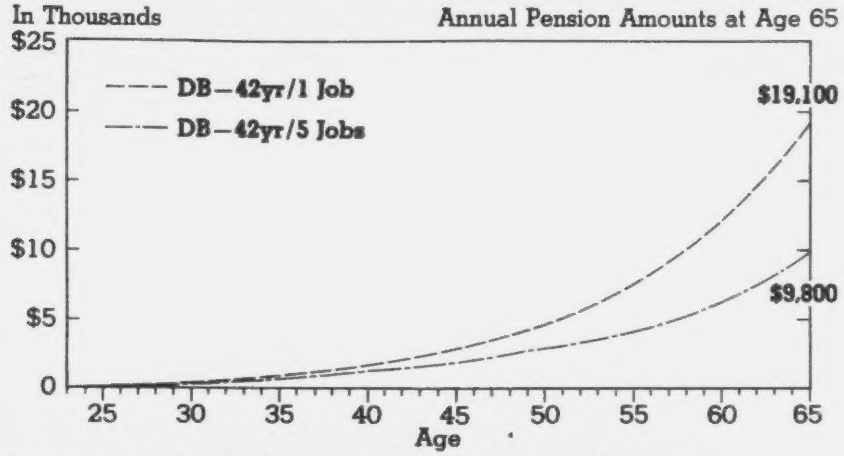
Defined Benefit Plans and Job Mobility Loss

An employee vested under a series of defined benefit pension plans can accumulate significantly lower pension benefits than an employee who remains under one pension plan for a full career. This is true even if all the plans have the same benefit formulas and the employees have identical salary histories. For this discussion, we will refer to the reduction in pension benefits caused by changing employers as job mobility loss. To calculate the loss, we first take the actual benefit that the employee will receive from all employers and divide it by the pension benefit that a mobile employee would have received if the last employer calculated the pension benefit based on the employee's full career service. Then we subtract this percentage from 100 percent.

Using an example developed by the Congressional Research Service (CRS) to illustrate the job mobility loss, we compare the annual pension benefits of two retired employees with identical salary histories and pension plan provisions who differ only in job mobility (see fig. 1). Each pension plan provides a retirement benefit equal to 1 percent of high-five pay for salary up to the average social security taxable wage base, and 1.5 percent above it (a common private sector practice called integration), multiplied by years of service. All amounts shown are in 1988 dollars. Under this final-pay plan, one employee works 42 years for the same employer while the other employee works for five different employers (2 years with the first employer, 5 years with the second, 10 years with the third, 10 years with the fourth, and 15 years with the fifth).

Figure 1

Impact of Job Mobility on Pension Amounts for Equal Cost Pension Plans



Starting pay of $20,000; Ending pay of $48,700. Constant (1988) dollars.

Source: Congressional Research Service

The mobile employee's total pension benefit from the five different plans would be $9,800, or about 51 percent of the nonmobile employee's single plan pension income of $19,100. In this case, the job mobility loss is about 49 percent. This loss would be smaller for a mobile worker whose pension coverage is not exclusively in defined benefit plans that use final pay formulas or for a worker with fewer job changes, slower salary growth, or an earlier retirement age. Furthermore, to the extent that a worker receives a second pension, such as a thrift plan, the overall retirement income loss would be less.

Components of Job Mobility Loss

Job mobility loss occurs because pension benefits under defined benefit plans often are tied to salaries, which typically increase throughout the worker's career but are only taken into account as long as he or she is continuously covered under the pension plan. Thus a loss occurs, for example, when a worker leaves a final-pay plan before retirement age. In this case, pension benefits are based on the worker's final average earnings at separation, rather than at retirement age, when the worker's earnings are likely to be higher.

The earnings growth over a career that causes job mobility loss is attributable to two factors:

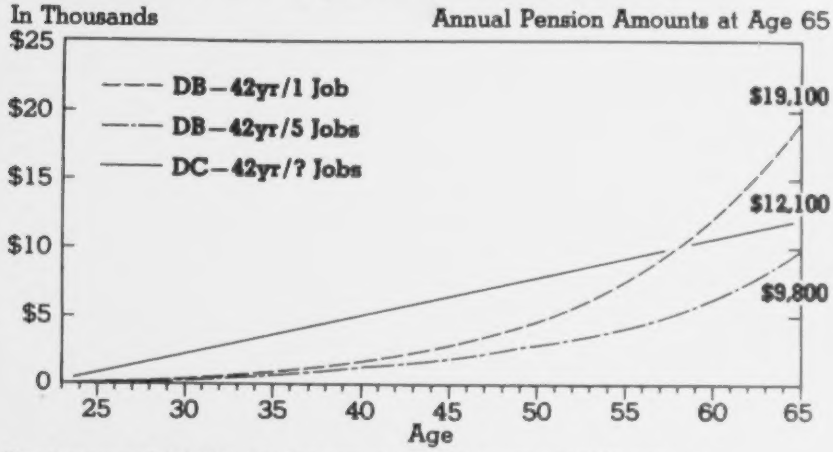
Inflation loss. Each time workers in defined benefit plans change employers, their vested pension benefits usually are retained by the employer and payment is deferred until retirement. Between the time the worker leaves a plan and benefit payments begin, the amount of the deferred benefit is frozen. Therefore, the purchasing power of the benefit is eroded by inflation. An inflation rate of 4 percent, for example, would reduce the real value of a pension benefit deferred for 15 years by about 44 percent.

Real earnings-growth loss. Presumably, workers become more efficient and effective at their jobs the longer they perform the same job tasks. In addition to wage and salary increases designed to offset inflation, employers may also compensate workers to reflect increases in their productivity that result from job tenure. Within-grade pay adjustments for federal workers are an example of productivity growth increases. Workers also receive additional wage and salary increases resulting from career promotions. Job mobility loss happens because future wage and salary gains are not recognized in calculating deferred retirement benefits.

Defined Contribution Plans and Job Mobility Loss

Workers in a series of defined contribution plans who are vested when they leave their employers' plans will not experience a job mobility loss if their pension assets remain in the plans or are rolled over into an IRA or a subsequent plan. This assumes the rate of return on the funds is the same no matter who manages them. The loss is avoided because the value of the pension assets, and hence retirement benefits, is based on the market performance of an investment fund, not on final earnings and years of service. Workers who become vested in two or more defined contribution plans over the course of their careers may do better than mobile workers vested in two or more consecutive defined benefit plans, as shown in figure 2.

Figure 2



Impact of Job Mobility on Pension Amounts for Equal Cost Pension Plans

Starting pay of $20,000; Ending pay of $48,700. Constant (1988) dollars.

Source: Congressional Research Service

This illustration, also developed by CRS, contrasts the earlier example of the two employees under defined benefit plans with an employee under a defined contribution plan of equal cost. The employee covered under the defined contribution plan, regardless of the number of job changes, would have an annual pension benefit of $12,100, or about 23 percent more than the mobile employee's total pension income of $9,800.

In summary, mobile workers vested under a series of defined benefit plans often accrue lower retirement benefits than do workers with comparable pension plans who work their full career for one employer. In contrast, the vested pension benefits of workers participating in defined contribution plans are not affected by job mobility. Even though workers in a defined benefit plan are at a disadvantage in terms of prospects for future pension income when they change employers, such plans offer employers and workers advantages not offered by defined contribution plans.

LIMITED PORTABILITY AND PRESERVATION ARRANGEMENTS EXIST

We have identified several examples of public and private pension plans that provide pension portability for mobile workers. In addition, under current law all workers who receive cashouts are permitted to use IRAs to preserve pension benefits until retirement.

Portability of Service

Portability of service--allowing employees to transfer years of service credit from one defined benefit plan to another--exists in the public sector, but only in limited cases in the private sector.

Social security is our nation's most portable pension system. It bases benefits on earnings over an employee's entire career, no matter how many times the worker changes employers. However, employment in positions not covered by social security results in no credit for that service. Since its inception in 1935, coverage under social security has expanded considerably, presently including almost all workers in the economy.

Examples of portability of service in the private sector include collectively bargained multiemployer plans, as well as networks of single-employer plans with portability or reciprocity agreements. In 1985, about 6.3 million individuals, or about 16 percent of all active private pension plan participants, were covered by about 3,000 multiemployer plans. The plans covering the Bell System companies provide an example of reciprocity agreements. Only about 8 percent of all single-employer pension plans have reciprocity agreements with unrelated employers, however, according to a 1981 study sponsored by the Department of Labor.

Portability of Assets

Portability of assets refers to the practice of giving workers a lump-sum cashout of their vested pension benefits when they leave a company's pension plan rather than deferring payment until retirement age. The cashout represents the present value of future benefits from defined benefit plans or the vested account balance from defined contribution plans. Under one legislative proposal, these assets would be transferred directly to a worker's IRA. Portability of assets is more common than portability of service.

Cashouts of assets generally take place at the plan sponsor's option. A cashout may occur under either a defined benefit or a defined contribution plan. An estimated 30 percent of participants in defined benefit plans and 82 percent of participants in defined contribution plans in 1984 were in plans that permitted cashouts of vested benefits under at least some circumstances, according to a 1986 study. Generally, cashouts from defined benefit plans were not large. Only about 3 percent of single-employer defined benefit plans accepted assets transferred from prior plans, according to a 1981 study for the Department of Labor.

Pension Preservation

The issue of preservation arises in those instances in which workers receive cashouts upon leaving pension plans. Currently, workers may preserve their pension assets for retirement by transferring them into IRAs or (in rare instances) other qualified pension plans, but in many cases workers spend the assets rather than roll them over.

Whether lump sums are saved or spent may affect income adequacy in retirement. Most workers who left their employer with cashed-out pension assets (about 95 percent) did not roll over the money into other retirement vehicles; only about 30 percent used the funds for any kind of investment, according to a 1986 study.

More workers may preserve pension assets in the future because of changes resulting from the Tax Reform Act of 1986. The law raised the cost of spending cashed-out pension benefits before age 59-1/2 in at least two ways: (1) it eliminated 10-year averaging for income tax purposes and (2) it imposed a 10-percent penalty tax on pension plan assets that are not rolled over into an IRA or other qualified plan. This essentially makes the treatment of lump-sum payments similar to the treatment of premature withdrawals from IRAs. Because of these changes, more workers may save their pension assets for retirement purposes.

IRAs are a currently available mechanism for mobile workers to preserve their cashed-out pension assets. Under current law, however, workers may not roll over their own previously taxed contributions into a successor plan or IRA. Also, plan sponsors may not directly transfer cashed-out pension assets to an employee's IRA or another employer-sponsored plan.

Although preservation of pension assets is an issue for both defined benefit and defined contribution plans, it is currently more of a problem with cashouts from defined contribution plans. This is because (1) in defined contribution plans pension assets build up faster during early years of plan participation when workers are most likely to change employers (see fig. 2) and (2) as we noted earlier, defined contribution plans generally cash out employees when they leave their employers. By contrast, in defined benefit plans (1) pension assets build up faster in later years of participation when workers' salaries and years of service are higher and (2) only a relatively small proportion of defined benefit sponsors allow terminating employees to receive lump sums of more than $3,500.

PROBLEMS AND TRADEOFFS IN IMPLEMENTING PORTABILITY AND PRESERVATION PROPOSALS

We have identified a number of options that seek to (1) maintain the value of pensions from defined benefit plans, (2) increase the portability of pension assets, and (3) encourage workers to preserve their cashed-out pension assets. Their primary goal is to help ensure adequate retirement incomes. Some options have been included in bills that have been introduced in this session of the Congress, while others that we have identified are based on earlier proposals or discussions in studies, the press, or other forums. These ideas include:

1. Maintaining the Value of Benefits From Defined Benefit Plans

   -- Increasing portability of service.

   -- Indexing deferred pension benefits.

2. Increasing Portability of Assets

3. Encouraging Preservation of Pension Assets

   -- Establishing a national portability clearinghouse to manage workers' pension assets from previous employers.

   -- Making it possible for plan sponsors to transfer cashouts directly to IRAs or other qualified retirement plans, rather than having to give pension assets to separating employees.

   -- Restricting workers' ability to spend cashouts before retirement or increasing disincentives associated with consuming cashouts.

   -- Allowing workers to roll over previously taxed employee contributions into IRAs or successor plans.

   -- Requiring retirees to receive their pensions in the form of lifetime annuities rather than lump sums.

The current legislative proposals that we have identified generally deal with options for encouraging the preservation of pension benefits and, to a lesser extent, with portability of assets. They do not address portability of service.

Maintaining the Value of Benefits From Defined Benefit Plans

Portability of service and indexing vested deferred benefits are two recognized methods for maintaining the value of mobile workers' pension benefits from defined benefit plans.

Under portability of service, workers' final employers would credit their workers' years of service with previous employers in determining pension benefits. This would eliminate the entire job mobility loss because it would effectively grant to all employees the higher benefits accruing to nonmobile employees that are depicted in Figure 1. For this reason portability of service would cause a substantial increase in cost, all other things being equal.

Alternatively, employers could index vested pension benefits. By using an inflation indicator as an index, such as the Consumer Price Index, pension benefits would be protected from inflation losses. By using an average earnings index, such as the social security average wage index, pension benefits would be protected from both inflation and productivity losses. Indexing deferred pension benefits would substantially reduce--but not eliminate--job mobility loss to the extent that workers' earnings over a career tend to increase faster than inflation and productivity gains. According to Congressional Budget Office estimates, indexing vested deferred pension benefits would increase the liabilities of a typical plan by 10 to 20 percent.

On the other hand, employers might reduce overall pension benefits to offset the increased cost. In this case benefits for nonmobile employees would have to be reduced to offset the higher benefits earned by mobile employees. Thus nonmobile employees would implicitly pay a price for portability of service or indexing of deferred vested benefits.

Some experts question whether the increased labor mobility likely to occur with greater portability of service or indexing of deferred vested benefits is good for the economy. They argue that employers need to be able to recoup investments in recruiting and training workers. Accordingly, one advantage of defined benefit plans is that they discourage turnover in the firm's work force. The loss of control over turnover could threaten the purpose of defined benefit plans as an instrument of personnel policy. Also, given the cost of portability of service or indexing and the generally heavier regulatory burden borne by defined benefit plans, defined benefit plan continuation and plan formation may be discouraged.

In addition, portability of service would pose substantial administrative problems:

-- Special cost-sharing arrangements would have to be implemented to avoid shifting the entire economic consequences of preventing job mobility loss to workers' final employers.

-- The paperwork burden on plans would be substantially increased because plan sponsors (or a central clearinghouse) would have to keep track of an employee's service under various employers and allocate costs among these employers.

- -- Coordinating the benefits of plans with different formulas or different actuarial assumptions would require a method of translating the pension credits of one plan into those of another.
- -- Inclusion of federal, state, and local employees in any portability or reciprocity scheme would have to be considered. State and local pension plans currently are exempt from many federal regulations.

Increasing Portability of Assets

Cashing out workers' vested pension assets would permit them to consolidate assets from two or more plans in an IRA or an account with a central clearinghouse. This could simplify workers' recordkeeping and retirement planning. It would also allow them or their estates to gain access to these assets in the event of disability, death, or other contingencies.

From the plan sponsor's point of view, paying cashouts would save plans the trouble of making small benefit payments. Also, defined benefit plan sponsors would not have to pay premiums to PBGC to insure the benefits of vested separated participants.

On the other hand, portability of assets generally would not increase workers' total pension benefits. In particular, it would not eliminate the job mobility loss in defined benefit plans because the value of the cashout is calculated on the basis of workers' final pay when they leave the plan. That pay is generally lower than their final pay at retirement. Pension experts who have examined proposals to increase portability of assets have identified the following problems with implementing these schemes.

- -- Increased portability of assets would necessitate increased liquidity in pension funds. Also, it would complicate funding of defined benefit plans, insofar as the plans' actuaries normally act on the assumption that the plan would begin to pay benefits at retirement age, not at the date of separation, which is more difficult to predict. Furthermore, defined benefit plan sponsors would incur an additional administrative burden in calculating appropriate cashout amounts.
- -- If portability of assets involves rolling over assets from a defined benefit plan to the worker's IRA (the most likely scenario), there would be a shifting of investment risk from the plan to the individual. This would make the retirement income security of workers less certain.
- -- Workers who were cashed out of a defined benefit plan at termination of employment would forgo any *ad hoc* postretirement benefit increases that might later be granted to the plan's retirees, if these increases are extended to recipients of deferred pensions.
- -- Encouraging cashouts from either defined benefit or defined contribution plans might increase diversion of pension assets to nonretirement purposes. This could occur even if these assets are initially rolled over into an IRA, unless measures to encourage preservation of pension assets are also implemented.

Ensuring Preservation of Pension Assets

Proposals aimed at preserving pension assets seek to encourage or require workers to roll over cashouts into an IRA or other vehicle in order to make it more likely that pension assets will be used for retirement. As such, these proposals generally do not pose the same tradeoffs as other proposals in terms of the operation of pension plans because they deal with the treatment of assets that have already been distributed from pension funds. However, there are certain practical issues to be addressed.

-- Spending pension assets before retirement may be less of a problem in the future because of the new rules contained in the Tax Reform Act of 1986. It is too early to determine the impact of these new rules, and hence the potential benefits of further restrictions are unclear.

-- When employees have some discretion as to how much money is contributed to a plan (e.g., 401[k] plans), additional restrictions on spending of assets may discourage them from using the plan to save for retirement.

-- Some preservation proposals would establish a central clearinghouse as the repository of cashed-out pension assets. Several experts have expressed concern that the decisions concerning how to invest the assets of a federally controlled fund could become a political issue.

-- Encouraging or requiring pension assets to be rolled over into successor plans and IRAs might increase retirement savings, but it would also likely reduce the revenue to the Treasury. This is because fewer premature withdrawal penalties would be collected and the investment income on these funds would accumulate tax-deferred.

-- We were not able to identify any studies indicating to what extent retirees withdraw assets from pension and IRA accounts in lump sums, rather than purchase annuities or otherwise spread pension income over their remaining lifetimes.

CONCLUDING OBSERVATIONS

The role of the private pension system has undergone substantial changes. Initially, the pension system was used primarily as a personnel management tool, allowing employers to reward long and loyal service and move people out of the work force with attractive retirement options. Over time, the Congress has sought to use pensions more as an instrument of public policy, adding requirements that help a broader cross section of workers to gain pension income. These dual purposes--personnel management and retirement income adequacy--can cause the system to work at cross-purposes.

Efforts to increase pension portability and preservation of pension assets aim to ensure adequacy of retirement income, but undermine the use of defined benefit plans as a personnel management tool. Our assessment indicates that implementing the portability proposals currently under discussion would entail difficult economic tradeoffs by employers, employees, and the federal government.

For employers, more pension portability could mean greater liabilities, additional administrative expenses, and an increase in labor turnover. Employers could react in various ways. For example, if the federal government does not pick up a substantial portion of the additional cost, employers may decide to shift to defined contribution plans as the primary pension plan. If this occurs, workers' retirement income will depend on the rate of return on their pension contributions rather than on a guaranteed benefit under a defined benefit plan. Some would find this course of action objectionable because the retirement income security of workers will be less certain.

Pension preservation proposals would have less of an effect on the pension system, unless greater portability of assets is also required. Increasing preservation of pension assets would constrain workers rather than plan sponsors. However, requiring defined benefit plans to cash out pension assets whenever a worker terminated employment would complicate funding and add administrative burdens.

- - - -

Mr. Chairman, this concludes my statement.

GLM Financial Group, Ltd.
20856 NORTH RAND ROAD, BARRINGTON, ILLINOIS 60010

July 12, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement of Committee's July 12 Hearing Record on S.2078 to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Please, please, please stop adding governmental regulations, interference, confusion and the related expenses to the tax code.

We strongly disagree with any attempt to make the current ESOP laws more confusing. We try to provide our employees with benefits and most of the laws you pass make it more difficult or impossible for us to provide these benefits.

Sincerely,

GLM FINANCIAL GROUP, LTD.

Charles Mauter

:es

c.c. Mr. Ed Mihalski

ACCOUNTANTS AND TAX CONSULTANTS

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TECHNOLOGY

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July 15, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We passionately believe in the concept of employee ownership of capital producing enterprises. This is the only way to improve America's productivity and living standard. Do not destroy the incentives that allow the ESOP concept to exist by passing S.2078.

The program exists and is being expanded today because it presents advantages to all parties. If these advantages don't exist, the concept will not expand.

We believe that the United Air Lines purchase will collapse because of its own weight and does not need this kind of legislation.

Very truly yours,

HSQ TECHNOLOGY

Henry D. Hoge
President

HDH:jwg

(In quintuplicate)

cc (5 copies): Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

California Contractor's Lic. 378393

HARRIS
BANK

July 11, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

I strongly oppose S.2078 and urge the committee to kill this bill. Requiring an employee vote on the establishment of any ESOP would seriously hamper Congress's stated goal of promoting employee ownership. In addition, it would not achieve anything for future participants in the plan because the great majority of plans being contemplated would never get off the drawing board. The additional amount of time and money required to seek approval would defer the establishment of an ESOP at the earliest stages. In the vast majority of cases, employees are far better off after the establishment of an ESOP than before. The only real concern should be when a company is terminating other profit sharing or pension plans and replacing those contributions with contributions to an ESOP and using an ESOP as the sole retirement benefit. In this case, the employees have a different level of risk in their retirement benefit. But this happens in a minority of cases. Why kill 95% of ESOPs when you only want to regulate 5%. Otherwise, employees are getting an additional benefit, and usually a large one, that not only serves to broaden capital ownership in this country but gives employees a stake in the competitiveness and therefore success of the companies they work for. S.2078 would hamper these goals and benefit virtually no one.

Sincerely,

Susan Glass de Padron

Susan Glass de Padron
Assistant Vice President
Harris Trust and Savings Bank

Copy to Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

LAW FIRM
Hertogs Fluegel
Sieben Polk
Jones & LaVerdiere
PROFESSIONAL ASSOCIATION

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S. 2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We have been assisting clients in implementing and administrating Employee Stock Ownership Plans for several years.

The main purpose of the Employee Stock Ownership Plan is to provide employees with an opportunity to share in the growth of their employer and become an owner in the company.

Many employees have no prior business knowledge. Some of them have never seen a stock certificate or possessed one.

The Employee Stock Ownership Plan also enables, in the case of the closely held business, an opportunity for the employees to acquire ownership of the company versus an outside entity who may or may not continue the business of the company.

Middle income and lower income employees may never have funds to acquire ownership in the business. Thus if their employer does not provide a retirement plan for its employees, these employees may be forced to rely on social security benefits upon their retirement which benefits could be quite nominal compared to their current income. As you can appreciate, the majority of individuals do not set aside funds for their own retirement.

The Employee Stock Ownership Plan enables employees to acquire ownership of an entity at no cost to them. The employer in essence is sharing its profits with the employee by making contributions either in stock or in cash to the plan on the employee's behalf.

If the law would require majority approval before the implementation of an Employee Stock Ownership Plan by the employees, we believe many employers would become discouraged by the complexity of and the time involved in the establishment of this retirement plan and may in fact decide against any retirement plan for its employees.

We thank you for your consideration.

Sincerely,

FOR THE FIRM:

Samuel H. Hertogs

Samuel H. Hertogs

INDEPENDENT APPRAISAL
INC.

Ms. Laura Wilcox
Hearing Administration
U.S. Senate Committee on Finance
Room SD 205
Dinkson Senate Office Building
Washington, D.C. 20510

SUBJECT: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Congress in 1974 passed the ERISA bill which President Ford signed into law on Labor Day 1974 as a start of the ESOP wave in America. I have appraised closely held companies from coast to coast since founding Independent Appraisal, Inc., in the Spring of 1975- well over 1,000 appraisals. I still appraise annually a dozen companies that I started appraising in 1975. These are small businesses that I have seen grow to medium sized businesses because of their aggressiveness and because of their ESOP. Several in the past thirteen years have become listed on the NYSE and ASE and many have become public companies.

As a member of the National Federation of Independent Businesses and of the ESOP Association of America, I urge you to not recommend passage of S.2078 for this would be a deterrent to the ease and cost-effective continued formation of new companies that should have ESOPs.

Pensions and Profit Sharing plans do not provide the incentives for employees that ESOPs do. Employees who "own a part of the company" become better employees, reap the benefits of their improved working conditions and retire with better programs. Congress has done well to continue to support the formation of ESOPs. Do not hinder this movement by interfering with more meaningless legislation.

Companies with ESOPs grow more rapidly than companies without. Increased revenue equals increased profits equal increased taxes. Non interference from Congress provides for growth of the economy and increased tax revenues. We need less government regulations and more freedom of choice for American Business.

Reject S.2078!

Respectfully Submitted,

Robert B. Wilkes, ASA
President of I.A., Inc. and
Business Valuations-Senior Member
American Society of Appraisers

STATEMENT ON PENSION PORTABILITY

by

EDWARD C. BERTNOLLI
CHAIRMAN, UNITED STATES ACTIVITIES BOARD
INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC.

on behalf of

THE AMERICAN ASSOCIATION OF ENGINEERING SOCIETIES

THE AMERICAN INSTITUTE OF CHEMISTS

THE AMERICAN SOCIETY OF CIVIL ENGINEERS

THE COUNCIL ON PUBLIC AFFAIRS OF THE
THE AMERICAN SOCIETY OF MECHANICAL ENGINEERS

THE ENGINEERS AND SCIENTISTS JOINT COMMITTEE ON PENSIONS

THE INSTITUTE OF ELECTRICAL AND ELECTRONICS ENGINEERS, INC.

THE NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS

JULY 25, 1988

Mr. Chairman and members of the Subcommittee, I am Edward C. Bertnolli of St. Louis, Missouri. I am Director of the Graduate Engineering Center and Professor of Electrical Engineering at the University of Missouri-Rolla. In this capacity I administer the University's Master of Science Programs in nine engineering disciplines plus computer science and serve as the principal liaison between the Center and supporting companies and agencies in the metropolitan St. Louis area. I am also the Vice President of Professional Activities for the Institute of Electrical and Electronics Engineers, Inc. (IEEE) and Chairman of IEEE's United States Activities Board.

I sincerely appreciate this opportunity to communicate the views, not only of IEEE members, but also those of the members of six other major scientific and engineering organizations on the need for further improvements in the nation's voluntary private pension system.

In this connection I'm pleased to report that IEEE's written statement has been formally endorsed by the following national organizations: The American Association of Engineering Societies (AAES), The American Institute of Chemists

(AIC), The American Society of Civil Engineers (ASCE); the Council on Public Affairs of the American Society of Mechanical Engineers (ASME), the Engineers and Scientists Joint Committee on Pensions (ESJCP) and The National Society of Professional Engineers (NSPE).

American Association of Engineering Societies (AAES) and Engineers and Scientists Joint Committee on Pensions (ESJCP) are umbrella organizations. The other groups are individual membership organizations. Together we represent more than 1,500,000 engineering and scientific professionals throughout the United States.

Pensions Profile and Current Concerns of IEEE Members

IEEE's membership profile and its members concerns about pensions reflect those of the other organizations that we are representing here today.

The Institute of Electrical and Electronics Engineers, Inc. (IEEE) is comprised of more than 290,000 electrical and electronics engineers and computer specialists, some 235,000 of whom live and work in the United States. Forty percent of its working U.S. members are employed by large corporations. Thirty five percent work for medium sized companies and an additional sixteen percent work for small businesses. Five percent are deans, professors or instructors at schools and colleges of engineering. Four percent are self employed on a full time basis. And six percent work as consultants to business or industry on a full or part time basis.

According to its most recent Salary and Fringe Benefits Survey, eighty-one percent of IEEE's U.S. members are covered by but not necessarily vested in pension plans offered by their employers (many of these are final average defined benefit plans). I say covered but not necessarily vested because the typical engineer changes jobs fairly frequently and is likely to have 3 or 4 employers over the course of his or her career. One third of the IEEE members whose employers offer pension plans are currently covered by plans that vest after 5 years. Even with the recent reduction of vesting standards from 10 to between 5 and 7 years, many of our mobile members will not vest in an employer sponsored pension plan.

Because of our members longstanding concerns about the extent to which the nation's voluntary pension system discriminates against mobile workers, IEEE/USAB and the other organizations that have endorsed our statement are dedicated to improving the retirement income benefits that are available to scientific and engineering professionals. To this end our organizations have worked since the early 1970's to encourage the development of employer sponsored pension and savings plans that will provide a greater measure of financial security for all Americans during their retirement years. Our organizations actively supported passage of the Employee Retirement Income Security Act (ERISA) in 1974, the Individual Retirement Arrangements (IRA) provisions of the Economic Recovery Tax Act (ERTA) in 1981, and the retirement equity (coverage, vesting, and integration) provisions of the Tax Reform Act of 1986.

In spite of major improvements in the nation's private pension and retirement savings system that have resulted from these legislative milestones, a number of deficiencies continue to limit the system's adequacy as a reliable source of adequate retirement income for many Americans.

We are concerned that about half of all working Americans, including many engineers and scientists, are not covered by an employer sponsored pension plan. Others who are covered will not collect any benefits at retirement and many of those who do will collect much less than they need to maintain a reasonable standard of living.

We are also concerned that America's private pension system discriminates against mobile workers and about the extent to which the system fails to meet the needs of those who are employed by small businesses.

We have also found that present law makes it difficult for very many Americans to build up supplemental retirement savings through their own self-thrift. It is no longer certain that a middle income worker in the private sector who is covered by a private pension plan and Social Security will be able to retire with an income sufficient to maintain his or her pre-retirement living standard. Even long tenured workers may find that the combination of a private benefit and Social Security is inadequate to meet their needs. These two sources, after all, currently replace less than 50% of the typical worker's pre-retirement earnings. Individual savings for retirement must be made a more important supplement to Social Security and private pension benefits.

We think it is essential that Congress move quickly to enact additional legislative incentives and mechanisms to encourage the establishment of a more flexible retirement system including employer sponsored plans and individual retirement income arrangements that will more adequately meet the needs of an increasingly mobile workforce in an increasingly competitive international economy.

The form and scope of such initiatives are a matter of considerable interest to our 1.5 million members who are involved in almost every aspect of American business and industry. Many are employed in the dynamic aerospace and defense electronics industry where contracts, projects and companies expand and contract, seemingly overnight, and where job changes are frequent and vested pension benefits are hard to come by. Another substantial segment of our members are employed in more stable industries, such as electric power and telecommunications, where long term service has traditionally been the norm. But even among these companies, pension problems have begun to surface. The recent rash of business takeovers, mergers, consolidations, and corporate downsizings has created unsettling situations which have dimmed the prospects of a secure retirement for many engineers and scientists.

A substantial number of our members are leaving the ranks of corporate employment to start small businesses of their own or to work as consultants or independent contractors. Such individuals must provide for their own retirement needs and possibly those of a handful of employees.

As you can see ours is a very diverse group of professional and technical personnel. Because of this diversity, our interests in and concerns about pension issues are also very broad-based. But today I would like to focus on three issues of substantial consequence to everyone in the American workforce.

As we see it, the major challenge facing the Congress and America's voluntary private pension system is to find ways to expand pension coverage, particularly among small businesses; to promote increased savings by individuals for retirement purposes; and to improve pension portability. With respect to pension portability, we are particularly concerned about the importance of preserving the purchasing power of pension benefits when workers change jobs.

Expansion of Pension Coverage

First, we see an urgent need to extend coverage to the substantial numbers of Americans whose employers do not currently offer pension benefits. We are concerned that after at least two decades of steady gains, coverage has leveled off at around 50%, and now seems to be declining. This topping out appears to coincide with the emergence of small business as the principal creator of new jobs. Current data from the Census Bureau indicates that less than 35% of the individuals who work for firms with fewer than 100 employees participate in any kind of pension plan and that less than 10% of the workers who are covered are likely to vest and thereby become entitled to future benefits.

If retirement plan coverage is to be extended significantly, it will have to be primarily among small firms.

In our view, Simplified Employee Pension Plans (SEPs) hold the most promise for expanding pension coverage among workers in small companies. Small businesses should be given financial and administrative incentives to offer employer funded SEPs, and, in addition, be required to offer SEPs on a salary reduction basis when no other company retirement savings vehicle is available.

Increased Incentives for Individual Retirement Savings

Second, we urge Congress to take a long-term view with regard to the tax treatment of individual retirement savings arrangements, and to enact legislation that will permit persons who change jobs before vesting in a pension plan to take an income tax deduction for amounts contributed to an IRA during the pre-vesting period.

Because the average tenure in today's mobile workforce has dropped to about 6 years, and continues to fall, a large percentage of covered workers never vest and never collect retirement benefits from any employer.

We believe the current system discriminates against short-tenured workers since they do not have access to retirement vehicles with the same kinds of tax advantages that are provided under tax-qualified pension plans.

In our view the previous and still current $2,000 per year limit on tax deductibility for IRA contributions will not provide an adequate retirement income for very many middle income workers. In the interest of equity, we also recommend that the IRA tax deduction limit for non-vested workers be set at a level consistent with qualified salary reduction plans, i.e. at $7,000.

Such a change would assist that segment of the workforce that hasn't vested. But what can be done to preserve the pension benefits of workers who change jobs after vesting in an employer sponsored plan?

Improving Pension Portability

Under current law, when a vested employee leaves a company before retirement there are two possible outcomes: either the actuarial present value of the employee's accrued benefits is distributed as a lump sum at the time of his or her departure or the monies representing earned benefits are retained by the plan for distribution when the vested employee reaches retirement age.

There is ample evidence that lump sum distributions received early in workers careers are frequently spent rather than saved for retirement, particularly the smaller amounts typically received by short tenured workers. And benefits that are kept in a former employer's defined benefit plan lose purchasing power over time due to the adverse effects of inflation. Even though inflation is no longer in the double digit range, it still remains sufficiently high to erode the purchasing power of pension benefits. Assuming that the current 4% inflation rate continues, a forty year old worker who changes jobs today will receive a pension benefit from his former employer when he reaches retirement age that has a real value of less than 40 cents on the dollar. In other words, inflation will reduce the purchasing power of the worker's retirement benefits by more than 60 percent.

Our 1.5 million members think that this is unacceptable. To the extent that pensions represent deferred wages, it can be argued that employees pay for their retirement benefits by accepting lower wages and should be entitled to receive the equivalent purchasing power at retirement.

This is not a radical notion. It is entirely consistent with the widely held conviction that benefits received during one's retirement years ought to keep pace with inflation. Social Security and most government sponsored pension plans subscribe to this viewpoint and index payouts. Isn't the concept of preserving the purchasing power of pre-retirement accumulations an equally valid concept?

To ensure that pension benefits remain intact when workers change jobs, several changes to present law are required. First, we recommend that lump sum cash outs of accrued benefits should be discouraged when employees change jobs. Instead, terminating employees in all pension plans should be given the option of choosing a rollover into some form of tax-deferred retirement arrangement, or of leaving the benefits in the former employer's plan, if the value exceeds some minimum amount, say $3500.

In keeping with the principle that pension benefits represent deferred wages whose purchasing power is to be maintained, we also recommend that the roll-over value of benefits accrued under defined benefit plans should be calculated on the basis of a deflated long-term interest rate of about 3% rather than an actuarial rate derived from market rates. This would provide true pension portability by defining and specifying the monetary value to be attached to the employer's promise when a vested employee leaves prior to retirement. True portability is achieved when there is a reasonable expectation that the purchasing power of accrued vested benefits will be maintained from the time of termination until the worker reaches normal retirement age. This condition is likely to be achieved when the rollover value is computed using a deflated interest rate and transferred funds are then invested at market rates.

In keeping with the principle of maintaining purchasing power we also recommend that accrued vested benefits that are left in a former employer's defined benefit plan from the time of job termination until retirement be indexed to maintain their purchasing power. This could be accomplished either by means of performance indexing wherein investments above a statutory real rate of return would be used to enhance pension benefits or through the use of index bonds whose nominal yield incorporates an inflation premium.

The present value of both rollover and retained job termination benefits in a defined benefit plan should be assized on the basis of the most valuable form of accrued benefits that would otherwise be available. The present value of transfers from defined contribution plans should be the combined account balance at the time of separation from service, in other words, the employer's and the employee's contributions plus investment earnings on both.

Another change to current law that is needed to achieve portability is to permit after-tax employee contributions to be added to before-tax contributions in roll-over retirement arrangements.

None of the above recommendations are new proposals, but they are needed now to give real meaning to the concept of pension portability and to remove a serious impediment to the kind of labor force mobility that is needed to maintain America's industrial and economic competitiveness.

We note with some concern that at least two of the pending portability proposals (HR 1992 and HR 2643) would require that every pension distribution be in the form of an annuity. We understand the intent behind these provisions but we believe that the potential for creating hardships in emergency situations outweighs the desire to assure long term income security.

One final recommendation. Hardly a week goes by that we don't hear of a troubling situation in which a relatively young vested employee dies leaving his or her survivors to discover that their loved one's pension plan makes no provision for paying benefits unless the participant dies after some threshold age, typically age 55. Congress should take steps to remedy this grievous situation. Vested benefits must be available to survivors should a pension plan participant die at any age before retirement.

Mr. Chairman, this concludes our testimony. I thank you for the opportunity to appear before this distinguished Subcommittee. The IEEE and the other scientific and engineering organizations that have endorsed our statement are dedicated to improving our nation's voluntary private pension system. We have worked to this end since the early 1970s. Although major advances have been made in the intervening years, significant shortcomings remain that need to be corrected. On behalf of our 1.5 million members, we look forward to working with the Congress and other concerned organizations to promote the enactment of legislation to expand pension coverage; encourage increased individual savings for retirement, and help to maintain the purchasing power of pension benefits when workers change jobs.

JAMESTOWN KLALLAM TRIBE
150 South 5th – Suite 2 • Sequim, WA 98382
Phone: (206) 683-1109 – (Fisheries) (206) 683-1001

July 18, 1988

The Honorable Max Baucus
706 Hart Senate Office Building
Washington, DC 20510
ATTN: Tim Vettel

Dear Senator Baucus:

I submit this letter and the enclosed "chronology of events" for inclusion in the July 12, 1988 hearing record on H.R. 2792 "Indian Fishing Rights Clarification" bill before the Senate Finance Committee's Subcommittee on Taxation and Debt Management hearing on "Miscellaneous Tax Bills."

In our treaties negotiated in the mid 1850's, our forefathers very clearly reserved the right to fish in their "usual and accustomed" waters. Although two separate Interior Department Solicitor opinions (1983 and 1985) supported the Tribal position that fish caught by tribal members were tax exempt, the Treasury Department maintained that fishing income could only be exempt if specific language was contained in the treaties. The first Federal income tax provision wasn't enacted until 1913 or approximately 60 years after our treaty was signed.

H.R. 2792 basically corrects this IRS injustice. We urge, however, that the House Ways and Means legislative language tying the exemption to the legislation be modified to ensure the exemption is coextensive to both the legislation and the treaty. Otherwise, ambiguities remain for interpretations that could further abrogate our treaty rights. We would also encourage consideration of "managing and rearing" inclusion as a fishing rights-related activity for exemption purposes as our forefathers certainly engaged in these activities to protect and enhance our salmon. And finally, we encourage the development of less complex rules for individual Indian or Indian-owned corporate processing activities to more accurately reflect the realities of Indian Country.

I urge you to support these refinements to H.R. 2792 and the passage of this measure in the remaining days of the 100th Congress. The U.S. Tax Court has already processed numerous tribal fishermen under this guise to diminish our treaty rights and IRS collection agents are poised to impose collection penalties if this issue is not resolved.

As a member of the Senate Finance Committee, your vote of support for Indian Treaty Rights and justice would be most appreciated.

Sincerely,

Wm Ron Allen

William "Ron" Allen
Chairman

Enclosure

WRA/sbt

KILSBY-ROBERTS

NEVEN C. HULSEY
President

July 13, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

When an acquisition involves utilizing an ESOP, it would be totally impractical to have the requirement of an employee vote to approve its establishment.

The time and money involved to assimilate and explain the myriad of issues involved to 660 employees scattered over multi-locations through the United States and England would be astronomical. A seller would have to have an unlimited amount of patience for such a program to be implemented.

Kilsby-Roberts would not be an ESOP Company today if Bill S.2078 had been in force at the time we decided to put our plan into effect. And that would be unfortunate because our company has never been as strong as it is today, and our employees are dedicated to its success because of the opportunities afforded them via our ESOP plan.

For the hearing record, our company strongly opposes the Armstrong ESOP Bill S.2078, as we feel it would create massive government regulations regarding the establishment of ESOPS and would seriously hamper the creation of new Employee Stock Ownership Plans.

Sincerely,

NCH/be

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

7306 Raccoon Hill
Kirtland, Ohio 44094
July 13,1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four copies are sent to be included in the Committee printed record of July 12, 1988 hearings.

As an active practitioner in the ESOP and corporate finance field, I find the proposed amendment counter-productive to achieving wide-spread employee ownership in America. In particular, small privately-held firms will be wary of such provisions. I firmly believe that ESOPs can play a crucial role in alleviating much of the disparity in capital ownership.
If the government would just stop changing the rules of the game, ESOPs can make a major contribution faster than would otherwise be possible.

Sincerely,

Andre J. Lukez

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Building
Washington, D.C. 20510

McDougal, Littell & Company
P.O. Box 1667 Evanston, Illinois 60204

Alfred L. McDougal President

July 15, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

If enacted, the Armstrong bill would create massive government regulations regarding the establishment of ESOPs and would seriously hamper the creation of new employee stock ownership plans. The bill would also require the Secretary of the Treasury to issue unspecified voting rights regulations.

Our company has had an ESOP since 1983 and we believe that its establishment has had only positive effects for our employees. We are already overburdened with continually changing legislation and believe ESOPs should have the opportunity to exist without additional legislative restrictions.

Yours sincerely,

Alfred L. McDougal/mjm

Alfred L. McDougal

mjm

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance

Charles E. Meaden, Esq.
48 Wall Street
New York, New York 10005

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Issues of corporate governance are not appropriate subject matter for the tax code. Senator Armstrong's proposed legislation would, I believe, create substantial uncertainties about the legal rights of a corporation's officers, shareholders and directors to effectively control corporate action under state law. ESOPs must not be made a test case for giving persons "voting rights" pertaining to a corporate entity which they neither own nor control; Senator Armstrong's proposed legislation would not only kill most ESOPs but would also precipitate an adverse market reaction by setting a precedent for a new corporate law principle pertaining to control and voting rights of employees as opposed to officers, directors and shareholders of a corporation.

Therefore, I believe that Senator Armstrong's proposed legislation should be rejected.

Sincerely,

Charles E. Meaden (kr)

Charles E. Meaden

CEM:kmr

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, D.C. 20510
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RALPH PETRANEK, Vice-President
H. GRIFF MASON, Vice-President Sales
L. H. HOLLEY, Secretary-Treasurer
D. D. AMMERMAN, Assistant Secretary

July 11, 1988

Ms Laura Wilcox
Hearing Administrator
U. S. Senate Committee on Finance
Room SD 205
Dirksen SEnate Office Building
Washington, DC 20310

Dear Ms. Wilcox:

Pursuanrt to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We strongly oppose the Armstrong ESOP bill. Our feeling is that it would discourage the creation of new ESOP's and result in the issuance of many unwieldy regulations.

Sincerely

L H Holley

L. H. Holley
Secretary-Treasurer
LHH/y

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Washington, DC 20510

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July 21, 1988

PERSONAL AND CONFIDENTIAL

Ms. Laura Wilcox
Hearing Administrator
U. S. Senate Committee on Finance
Room SD205
Dirksen Senate Office Building
Washington, D. C. 20510

Re: Statement for Committee's July 12 Hearing Record on S. 2078, to Require a Majority of Employees to Approve the Establishment of an ESOP

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S. 2078 (Committee press release H-28), this letter and four copies are being sent to be included in the Committee Printed Record of the July 12, 1988 hearing.

Our firm is one of the most active firms in the country in establishing ESOPs. I have personally been involved in establishing ESOPs since 1968, and our firm has specialized in designing and implementing ESOPs since 1974.

BACKGROUND FACTS

Excluding PAYSOPs and tax credit ESOPs, which are no longer permitted as a result of the Tax Reform Act of 1986, there are only four to five thousand ESOPs in the country. At least 90% of these ESOPs have been adopted by small- to medium-size, privately held, nonunion companies. About half of these plans are new plans. About 25% of these plans have been adopted as a replacement of a prior profit sharing plan. About 25% of these plans have been adopted as an amendment and conversion of a prior profit sharing plan. Less than 1% of these plans have been funded as a result of the replacement of a prior defined benefit pension plan.

Under existing law, a nonunion company is free to adopt any kind of qualified plan that it wishes, and it is free to change from one plan to another as circumstances warrant.

Under existing law, any plan that includes union employees cannot be either established or terminated without notice to the union employees and without the opportunity to negotiate the terms of the plan.

ISSUE NUMBER ONE

Should a majority vote of employees be required in order to establish an ESOP?

ANALYSIS. As indicated above, under existing law, nonunion employers are free to pick and choose whichever type of qualified plan they desire to implement, and they are free to change from one type of qualified plan to another type of qualified plan from time to time. The decision to implement an ESOP is entirely a company decision, assuming that there are no salary reductions involved. The implementation of a qualified plan has been regarded by all of the courts and by all of the regulatory agencies, including the IRS and the SEC, as being in the nature of a bonus similar to deferred compensation. I can see no justification, for requiring that employees must be given a vote on this matter before they can receive a bonus or before the company can implement a particular type of qualified plan.

Nor can I see any justification for singling out an ESOP as opposed to a stock bonus plan or a profit sharing plan. A stock bonus plan is identical to an ESOP, except for the ability to leverage the purchase of company stock, and except for certain special tax benefits available to ESOPs.

ESOPs are designed to encourage broad ownership of capital. The contribution rate to ESOPs is typically twice as great as it is to other forms of benefit plans, such as stock bonus plans, profit sharing plans and pension plans. Since ESOPs provide a substantial employee benefit, they should be encouraged as much as possible. Establishing a requirement that the employees much preapprove the establishment of an ESOP would completely discourage ESOPs, and result in reducing employee benefits available to employees.

In the case of union employees, existing labor law already grants union employees the right to engage in collective bargaining with respect to all forms of wages and compensation, including qualified retirement plans. Accordingly, I cannot see that S. 2078 accomplishes anything with respect to unionized employees.

With respect to nonunion companies, the requirement that this matter be subject to a vote would be tantamount to making every company engage in collective bargaining.

ISSUE NUMBER TWO

Should employees be entitled to vote on whether or not assets may be transferred to an ESOP from another plan?

ANALYSIS. Again, in the case of a unionized company, the proposal is unnecessary and redundant, since employees already have the right to engage in collective bargaining with respect to the termination of a plan and the implementation of a successor plan.

With respect to nonunion companies, existing law imposes a high degree of fiduciary liability upon plan fiduciaries who engage in transactions which result in a loss or diminution of plan assets. Under existing law, if prior profit sharing funds or pension assets are to be transferred to an ESOP, the fiduciary has two options. First, he can make the decision himself, subject to being held liable for breach of fiduciary obligation. Secondly, he can put the matter to an employee election. Existing law should not be changed in this regard. In most cases, the employees do not have sufficient investment experience and sufficient investment information to make intelligent elections. Holding the fiduciary responsible for this decision will result in a higher degree of fiduciary protection than if the employees exercise their own elections.

Further, if employees are to be entitled to exercise discretion with respect to any transfer of assets, why should they not be allowed to exercise discretion on any major change of investment strategy? If employees are to be involved in every major investment decision, then all qualified plans would become 401(k) plans, and the concept of a plan fiduciary would be eliminated entirely.

ISSUE NUMBER THREE

Should employees be entitled to exercise voting rights with respect to stock held under an ESOP?

ANALYSIS. Under existing law, voting rights must be passed through in any ESOP that is maintained by a publicly held company. In privately held companies, voting rights need be passed through only with respect to major corporate issues.

Based on my experience, voting rights should not be passed through in privately held companies for the following reasons:

1. Passing through voting rights in privately held companies would completely destroy the existence of ESOPs. Ninety-five percent of all existing ESOPs would be terminated within six months, and the implementation of new ESOPs would cease overnight. No business owner would want to sell stock to his employees if it is obvious that he will lose control. Consider that in most cases there are several owners of stock, even in a closely held corporation. Thus, an additional 10%, 20% or 30% percent of stock in the hands of employees could easily upset the control of most privately held companies.

2. Passing through of voting rights completely eliminates the whole concept of a trust arrangement. The very essence of a trust is that it separates beneficial ownership from title ownership. It enables an owner to give away part of his rights without giving away all of his rights. These existing trust principles have existed for hundreds of years. Giving the employees all of the rights of direct ownership is tantamount to saying that trust arrangements are no longer legal.

3. Why should voting rights be required to be passed through in ESOPs, but not in stock bonus plans, profit sharing plans, and pension plans? If employees are allowed to vote shares of company stock in an ESOP, why should they not be allowed to vote all shares of stock of any kind held under any type of qualified plan?

4. Studies conducted by the National Center for Employee Ownership (NCEO) and others have found that employees generally are not interested in voting rights. Employees definitely should be given more participation in decisions affecting their own areas of expertise and in the manner of performing their own jobs. The NCEO study found, however, that the availability or nonavailability of voting rights had almost no impact upon the employee approval of the plan.

5. ESOPs were never intended to be employee co-ops. The pass through of voting rights is an essential element of employee cooperatives. It is not a requirement for an ESOP, nor should it be. Over the past two hundred

years in this country, and throughout the world, despite many attempts, there have been few, if any, successful employee cooperatives. Putting management decisions in the hands of large groups of employees is simply not good management practice, and almost all students of management science, ranging from Peter Drucker (Management) to Peters and Waterman (In Search of Excellence) would strongly advise against putting management decisions in the hands of employees. Management decisions cannot be effectively made in large groups. The result is often chaos. Moreover, history has shown that employees are seldom able to make hard decisions when it is necessary to cut back salaries or to lay off employees in order to save a business.

CONCLUSION

Senate bill S. 2078 is an ill-advised bill. It was apparently drafted in order to assist one group of union employees at United Airlines in overruling the wishes of another group of union employees. If an Act of Congress is needed to resolve this specific dispute, then a specific bill should be addressed to this particular matter. In any event, one existing transitory dispute should not be allowed to make bad law for thousands of other companies.

Sincerely,

MENKE & ASSOCIATES, INC.

John D. Menke

John D. Menke
President

JDM/js

cc: Mr. Ed Mihalski

MERCER CAPITAL
MANAGEMENT, INC.

P.O. Box 41856 Memphis, Tennessee 38174 (901) 725-0352

July 20, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We would like to point out the following:

1. An ESOP is a defined contribution employee benefit plan which must conform to the guidelines established by ERISA. A 1986 study by the United States General Accounting Office found that 91% of ESOP employers started their plans to provide a benefit to their employees.

2. Like all other employee benefit plans, the establishment of an ESOP is subject to the discretion of the board of directors of the company (which is ultimately responsible to the shareholders). Boards of directors are not currently, nor have they ever been, required by law to obtain a majority vote of their companies' employees for the establishment of any other benefit or retirement plan.

3. The employees of a company are not normally in a position to decide the efficacy of an ESOP or any other employee benefit plan. The benefits to be bestowed upon employees (health and life insurance, retirement plans, profit sharing plans, stock option plans, product discounts) are the prerogative of the management or policy makers of the company. Although they may be offered "cafeteria style" benefits packages, employees rarely if ever have the opportunity to vote on the establishment of any of these benefits. Employees are not always shareholders.

4. The Internal Revenue Service validates the tax deductibility of an ESOP in the same manner as it does other employee benefit plans. In other words, the IRS considers an ESOP to be an employee benefit.

5. The Department of Labor insures equitable treatment for all eligible participants in an ESOP. Thus, in general no employees can be placed at a disadvantage, in terms of benefits, relative to other employees.

In our opinion, the requirement for the majority approval of an ESOP by the sponsoring company's employees is unwarranted. The establishment of an ESOP is a business decision to be made by management. An employer making this business decision hopes to provide employee benefits and improve employee morale, in return for improved productivity and tax incentives. These are all motives of the employer and decisions which have always been (and should always be) made by the employer without limitations or restrictions as suggested by S.2078.

Sincerely,

MERCER CAPITAL MANAGEMENT, INC.

Z. Christopher Mercer, CFA, ASA
President

ZCM/dh

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
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MID AMERICA
POWER DRIVES
MANUFACTURING & DISTRIBUTING INC.

July 18, 1988

Ms Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms Wilcox;

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Mid America Power Drives Mfg. & Dist., Inc., opposes the enactment of S.2078 because of the additional record keeping that would be required under this legislation.

Sincerely,
Mid America Power Drives

Gregory S. Jude

Gregory S. Jude
Treasurer

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

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July 15, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. SENATE COMMITTEE ON FINANCE
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearing.

Modernage, as an ESOP Company, strongly object to the provisions of S.2078. We believe that this legislation, if enacted, would create massive government regulations and would seriously hamper the creation of new employee stock ownership plans.

Establishing an ESOP for any company, is a long, complicated, and rather expensive undertaking, and S.2078 would only add an additional burden that I feel is hardly necessary.

The establishment of ESOP Companies has proven to be a wonderful way to assure the continuation of the private enterpreneurship system in an age of business mergers and takeovers.

Sincerely,

Benjamin Bennett
Secretary Treasurer

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

STATEMENT ON
S. 2484
THE RESEARCH AND EXPERIMENTATION CREDIT
EXTENSION AND REFORM ACT OF 1988
BY
PAUL R. HUARD, VICE PRESIDENT
TAXATION AND FISCAL POLICY DEPARTMENT
NATIONAL ASSOCIATION OF MANUFACTURERS
SUBMITTED TO THE
SENATE FINANCE SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
FOR
JULY 12, 1988
HEARINGS

I am Paul R. Huard, Vice President for taxation and fiscal policy of the National Association of Manufacturers. On behalf of our members, I am pleased to have this opportunity to present our views on S. 2484, which would establish a permanent 20% tax credit for research and development (R&D). While technically the original legislation used the phrase "research and experimentation credit," the term R&D has acquired such common usage that it will be used in place of the less familiar R&E.

NAM supported the original R&D tax credit and the 1986 extension, although we had some reservations about the limitations therein. NAM also strongly supports the establishment of a permanent R&D tax credit. Of the existing bills, we consider S. 2484 preferable to earlier proposals, which merely would have made the tax credit as it exists in current law permanent. In contrast to this prior legislation, S. 2484 would effectively eliminate or at least reduce most of the defects in the 1986 law. Further, by making the credit permanent, it would be possible to eliminate much of the uncertainty associated with the current existence of a temporary R&D credit, which must be renewed from time to time by Congress, and which for this reason creates considerable doubt as to the real after-tax costs of R&D projects expected to last beyond the expiration of the current credit. Therefore, we urge this committee to send this bill to the floor of the Senate for passage prior to the expiration of the existing R&D credit at the end of 1988.

This statement is organized as follows. Section I briefly reviews the legislative history and usage of the R&D credit. Section 2 examines defects in existing law. Section 3 examines the improvements in S. 2434 relative to current law. Section 4 examines the generic case for the R&D tax credit based on historical and international data.

1. The Existing Legislation

The R&D tax credit was first enacted at a 25% rate in 1981 on a temporary basis until 1985, and was subsequently extended for two years by the Tax Reform Act of 1986 at a diminished rate of 20%. The credit applies only on an incremental basis, *i.e.*, it applies only to the amount by which current year qualifying research expenditure exceeds a base defined as the average amount of R&D expenditure over the three preceding years. Several limitations apply to the credit. In the original 1981 version, base period research expenses were limited to no less than 50% of qualifying research expenses for the determination year. In essence, this restricts the credit to the lesser of the excess of current year expenditures over the average of the three previous years, or 50% of current year expenditures. A second restriction enacted in 1986 is that the credit can reduce tax liability only according to the formula of $25,000 plus 75% of the tax liability over that amount. It is therefore conceivable that firms may find themselves in an excess credit situation, and be forced to carry the unused credit forward or back. Finally, the law incorporates some ancillary provisions, including expensing of R&D under specific circumstances and the University Basic Research Credit, which applies incrementally at a 20% rate to corporate payments to universities.

The uses of the R&D tax credit have been described in a recent report by the General Accounting Office. The vast bulk has been used by large corporations, with assets of $250 million or more (77.6% in 1981-84), with a smaller percentage used by firms with assets below this threshold and an insignificant residual used by individuals. On a sectoral basis, the overwhelming bulk of the R&D tax credit earned in 1981-84 was comprised by manufacturing firms (83.3%), followed by communications (8.9%), finance, insurance and real estate (2.4%), with other industries making up the residual. The distribution of the credit actually used, rather than earned, is similar. Within manufacturing, the breakout of the R&D credit earned is as follows. Office machinery: 18.1%, chemicals: 13.3%, electrical machinery: 14.6%, motor vehicles: 8.5%, instruments: 6.6%, aerospace and shipbuilding: 5.7%, pharmaceuticals: 5.8%, and other manufacturing: 10.8%. In this sense, the R&D tax credit has not operated as a special-interest subsidy benefiting only a few select industries. Rather, it has applied to a broad range of manufacturing sectors, benefiting a wide variety of products. While the credit has applied primarily to manufacturing rather than services, this merely reflects the fact that industry is inherently more research-intensive.

2. Defects in Existing Law

Several defects in existing law can be noted. The first is that the base limitations have effectively prevented corporations from taking full advantage of the credit. A related problem is that if current research expenditure exceeds the base amount by more than 200%, the value of the credit is reduced by half. In other words, under 1981 law the credit would be reduced to 12.5%, and under 1986 law it would be reduced to 10%.

The drawbacks associated with the base limitation provisions are fully documented in the recent report by the General Accounting Office. For instance, in 1981, out of qualifying research expenditures of $19.1 billion, the credit actually earned amounted to $619.4 million while the credit that would have been earned without the 50% base limitation totaled $651.8 million, a difference of $32.4 million. In 1982, the difference between the credit actually earned and the theoretical credit without bases limitations amounted to $15.0 million, while preliminary estimates on the basis of incomplete data for 1984 place this disparity at $5.8 million.

In other respects also, the base period constraints have reduced the value of the credit that is actually earned by corporations. In situations where qualified research expenditures are less than the base period amount, the firm receives no credit. According to GAO estimates, fully 21.8% of research exenditures failed to qualify for the credit in 1981, while this share increased to 29.1% in 1982, 38.3% in 1983 and an astonishing 43.6% in 1984. As noted above, in situations where qualified research expenditures are more than double the base period amount, the applicable credit is reduced by half, to 12.5%. Again citing GAO estimates, the share of qualified research expenditures thus reduced was 11.4% in 1981, 9.1% in 1982, 6.5% in 1983 and 4.5% in 1984. This means that of total eligible research expenditures, only 66.8% qualified for the full 25% credit in 1981, while 61.8% qualififed in 1982, 55.2% qualified in 1983 and 51.9% qualified in 1984.

Clearly, the base period constraints have diminished the value of the credit to firms. Without these constraints, the credit would have had a greater value for eligible companies, and would in all likelihood have exerted a greater stimulative impact on research.

A second defect in current law is that in disallowing research expenditures by start-up firms, the existing credit effectively prevents any member of small firms from qualifying for the credit. In many instances, there is a prolonged period of research required preparatory to entering the market; the result is that R&D undertaken before the firm is established in a regular trade or business automatically becomes ineligible for the credit. According to a recent study by the Small Business Administration, a significant share of R&D by smaller and start-up firms has been excluded from qualifying for the credit on account of this provision.

A third defect is that the definition of the base, which is determined in reference to historic R&D spending, has tended to create distortions in the intertemporal allocation of research. As previously noted, sharp fluctuations in R&D spending may cause qualifying expenditures to exceed the ceiling. Consequently, in order to make certain that all its eligible R&D actually qualify for the credit, firms have an incentive to forgo research, either to reduce the base or escape the limitation. It is readily apparent that this can lead to economic inefficiencies. For instance, firms in relatively slow growth or cyclical industries may receive disproportionately low access to the credit, due to the fact that their R&D is likely to fluctuate sharply in proportion to sales.

Finally, there is as yet little evidence that the limitations on deductibility of the credit enacted in 1986 are resulting in a diminished real value of the credit. The only data on this issue dates back to 1984, and does demonstrate that about one-fifth of the total value of the credit was carried forward or back. The GAO estimates that 91% of the available credit was applied against current tax liabilities in 1982, although this share diminished to 78% in 1984 as an increasing percentage of the available credit was carried forward or back. More specifically, in 1984, the available credit came to $1,697.5 billion, of which $1,144.3 billion was applied to current tax liabilities, $372.7 million was carreid forward, and an estimated $180.6 million was carried back. However, this does not indicate that the credit itself was at fault, merely that other factors placed any number of firms in an excess credit situation.

3. Improvements in S. 2484

S. 2484 offers several improvements over the existing R&D tax credit. First, in contrast to the floating base provided under current law, S.2484 provides a fixed base, defined as its average annual R&D expenditure in 1983-87 plus 7%. Beginning in 1990, the base would be indexed to the annual growth in current dollar GNP, subject to the limitation that it can never be less than 50% of current expenditures in the computation of the credit. In this manner, the distortions associated with the current base limitations are substantially reduced, albeit not eliminated altogether. They are further mitigated by the fact that firms have a choice of the regular tax credit — 20% of the difference between current expenditures and the base — or the alternative credit calculation — 7% of the difference between current expenditures and 75% of the base. This gives firms a greater degree of flexibility in deciding how to compute the credit.

Secondly, the revisions in S.2484 would allow most start-up firms to qualify for the credit. Firms which did not have R&D expenditures for the full period 1983-87 would instead compute their base by using a weighted average of the years for which R&D spending was undertaken, and then phasing in the historical base period amount in subsequent years. The net result is that start-up firms would gain access to the credit much more rapidly than under current law.

There is of course room for further improvements. While the revisions to the base in S. 2484 described above yield a better system than current law, we see no inherent reason why the base should be restricted to not being less than 50% of current expenditures. This committee should given some consideration to eliminating or at least modifying this restriction. At the same time, the effectiveness of the R&D credit would undoubtedly be enhanced if it were to be exempted from the new corporate alternative minimum tax (AMT). With the AMT in place, a certain amount of available R&D credits will hve to be carried forward or back, thereby reducing the real current value of the credit to firms and diminishing the implicit incentives to carry out new research.

4. The Generic Case for the R&D Tax Credit

The economic significance of R&D spending is considerable, since it exerts a direct if long-run influence on potential output and secular productivity growth. Potential output, normally interpreted as the long-term trend growth rate of the economy, is modeled as a function of technological change plus weighted factor inputs of energy, capital and labor. Until recently, technological advance was frequently thought of as disembodied from the factor inputs to production, with the result that it could be approximated as an exponential trend. Recent research, however, and increased availability of data on R&D both indicate that technological change exhibits cyclical behavior and is strongly influenced by current economic conditions. If technological advance is in fact endogenous, legislative measures such as the R&D tax credit should exert a powerful influence on research activity and therefore indirectly on potential output and productivity (since productivity is simply the ratio of output to labor, increases in the technology share of output will tend to raise this ratio).

The precise impact of the R&D tax credit on actual research expenditure is difficult to estimate econometrically due to insufficiently long time series; part of the problem is that R&D data is collected annually, unlike the NIPA which are computed on a quarterly basis. For instance, it has been possible to quantify the impact of the investment tax credit (ITC) due to greater data availability. Single equation estimates suggest that for every dollar of revenue lost to the Treasury, about $0.45 in new investment is generated, while when full feedback from the resulting growth in GNP is taken into account, this figure rises to $0.82 per dollar of revenue lost. This illustrates that targeted tax credits are generally very powerful mechanisms for generating economic responses. However, it is not known if the magnitudes resulting from the R&D credit are comparable.

In the absence of econometric estimates, it is nonetheless of interest to briefly review the historical data. Table 1 gives the growth rates of real R&D spending for the United States as a whole, by the Federal government, private industry and universities. The deflators for R&D spending are calculated by Battelle, and this figures should therefore be regarded as tentative.

The need to retain tax incentives for R&D outlays is evidenced by the deterioration of R&D spending during the early 1970s. During the early 1960s, the United States underwent consistently rapid growth in R&D spending, with real expenditures increasing by 3.6 percent per year in 1961-67. Starting in the latter part of the decade, however, R&D spending slowed appreciably, turning negative in 1970-73. Part of the reason was the decline in Federal government R&D spending associated with a reallocation of Federal activities from defense to social welfare. However, since industrial R&D also fell, there were clearly other reasons. One intriguing posibility is the repression of real after-tax profit margins by the effects of higher inflation on the capital consumption and inventory valuation adjustments, and the fact that the 1971-74 price controls worked primarily by depressing profit margins in relation to wages. The recovery of 1975-80 was associated with a major recovery in R&D expenditures, although this has to some extent to be interpreted as a rebound effect following several years of depressed R&D spending. It is clear that these growth rates were not sustainable.

The interpretation of the data for 1981-88, which includes two years of forecasted rather than actual data, is ambiguous. Superficially it would appear that the R&D tax credit did not have much effect, since R&D spending apparently felll in relation to the late 1970's. However, as pointed out above, the rates of growth achieved during the late 1970's were unsustainable. One closer examination, the weakness in R&D spending in 1983 is attributable to the constriction of profit margins in the wake of the recession during the previous two years. In 1984-86 as well as in 1981-82, there is evidence of a favorable upward shift in R&D spending, which roughly parallels the magnitudes achieved during the early 1960's. Moreover, the data for 1987-88 cannot be taken as reliable, since these are estimated on the basis of forecasts by the independent research firm Battelle. It would be tempting to link the slowdown in industrial R&D growth reported in 1987-88 with the reduction in the magnitude of the credit, but this is impossible to establish with any certainty.

A second reason why these estimates cannot be taken as definitive is that they differ from Federal government estimates. For instance, the National Science Foundation estimates that total R&D grew by 5.2% in 1975-82, 5.5% in 1982-87, and 3.3% in 1987-88. The same estimates for industrial R&D are 6.0% in 1975-82, 4.3% in 1982-87, and 2.6% in 1987-88. In other words, the NSF estimates corroborate the Battelle estimates to the extent of showing a similar pattern of rapid growth in the late 1970's and early 1980's, but slower growth during the last two years. Irrespective of which series is preferred, the effects of the R&D credit remain difficult to dientangle in view of the other special factors during the 1980's which led to increased R&D activity such as increased defense spending and the SDI program.

Quite apart from the domestic statistics, a further rationale for making the credit permanent has to do with the share GNP comprised by R&D in the major industrial countries. Table 2 provides this data for selected years. In terms of total R&D spending, the United States has exhibited the highest share of GNP of all the major industrial countries except the Soviet Union. The Soviet Union is not really comparable, however, both because its true GNP is difficult to estimate with any degree of accuracy, and because its centrally directed economy inhibits the commercialization of new technologies, meaning that a large amount of its research is never reflected in higher real growth rates. Nevertheless, an altogether dissimilar picture emerges when military and defense-related research is excluded. Non-military research as a share of GNP was lower in the United States than in West Germany and Japan, while roughly on a level with France and the United Kingdom. Under these circumstances, making the R&D credit permanent will place American industry on a more competitive footing vis-a-vis its foreign counterparts. It should be noted in this respect that most of the major industrial countries provide explicit or implicit subsidies to R&D, either through the tax code, or through governmental allocations through nationalized corporations and public sector research facilities.

5. Conclusions

The existing R&D tax credit appears to have provided meaningful incentives for research spending. However, enactment of S. 2484 would be preferable to making the existing R&D tax credit permanent, inasmuch as it would eliminate many of the defects in existing law, particularly those originating in the definition of the base and limitations on eligibility.

Table 1: Estimated Real Growth Rate - R&D Spending

Year	United States	Federal Government	Industry	Universities
1961	3.2	3.8	2.6	3.0
1962	3.7	5.0	2.8	4.0
1963	3.8	5.2	2.8	5.5
1964	3.4	4.4	2.4	6.0
1965	3.9	4.7	3.0	7.5
1966	3.7	3.5	3.3	6.6
1967	4.0	3.9	3.6	6.9
1968	2.6	2.2	2.4	5.4
1969	1.0	0.7	.9	2.9
1970	-1.3	-1.4	-1.4	-0.8
1971	-2.6	-2.2	-3.1	-1.0
1972	-3.7	-6.9	-3.8	-0.2
1973	-0.8	-1.6	-1.1	1.0
1974	0.0	-1.6	.1	1.2
1975	2.8	-1.6	3.7	3.1
1976	2.7	-0.7	3.3	3.5
1977	3.6	-0.7	4.6	3.5
1978	4.0	-0.7	5.2	2.6
1979	5.5	1.2	6.7	2.1
1980	5.7	1.2	7.2	3.9
1981	4.1	1.2	5.2	2.3
1982	2.8	1.3	3.4	1.1
1983	1.2	2.1	1.1	1.0
1984	3.7	1.3	4.2	2.9
1985	3.1	1.2	2.8	5.7
1986	3.2	0.6	3.5	3.1
1987*	2.2	0.4	2.5	2.3
1988*	2.2	0.4	2.5	2.5

*Projections by Battelle, Inc.

Source: Nominal dollar data from National Science Foundation. Deflators computed by Battelle, Inc.

**Table 2: R&D Expenditures as a Percent of GNP,
Major Industrial Countries, Selected Years**

	Year	United States	West Germany	Japan	France	United Kingdom	Soviet Union
A)	**Total R&D**						
	1972	2.35	2.20	1.86	1.90	2.11	3.71
	1978	2.14	2.24	2.00	1.76	2.24	3.54
	1981	2.35	2.44	2.38	2.01	2.41	3.75
	1983	2.25	2.54	2.61	2.15	2.25	3.82
	1985	2.69	2.67	2.77	2.31	2.42	3.74
B)	**Non-military R&D**						
	1972	1.60	2.08	1.84	1.58	1.56	-
	1978	1.63	2.10	1.98	1.41	1.61	-
	1981	1.81	2.34	2.37	1.50	1.72	-
	1983	1.87	2.43	2.60	1.69	1.60	-
	1985	1.86	2.53	2.75	1.85	1.71	-

Source: National Science Foundation.

Statement of the

National Fisheries Institue

Subcommittee on Taxation and Debt Management

Senate Finance Committee

The National Fisheries Institute (NFI) appreciates this opportunity to file a statement in support of S. 1821. This bill would treat those seafood processing workers who are compensated on the basis of the amount of seafood they process as independent contractors for federal tax purposes.

NFI is the largest trade association representing the U.S. fish and seafood industry with over 1,000 member companies located throughout the United States. Our members operate seafood processing plants in almost all U.S. commercial fisheries.

A comprehensive study of the U.S. seafood processing industry found that only 6 percent of the companies in the industry had annual sales in excess of $10 million. Over half had sales of less than $250,000 and employed less than 40 people. Most companies, therefore, are small businesses, many of which are family owned.

Large seafood processing plants in the U.S. tend to rely upon imports for their raw material, are highly mechanized, and produce branded packaged goods. Production levels tend to be stable and workers in these plants are paid on an hourly or annual basis.

This is not the situation in many smaller plants. While no single operation typifies the smaller plants, many of these plants process locally-produced seafood through labor-intensive operations. These plants often are located in rural coastal communities where long-standing industry traditions and employment practices have evolved. This is particularly true for such traditional operations such as oyster shucking, crab picking and the hand filleting of fresh fish.

Because these smaller plants purchase raw material from local fishermen, the amount they process each day varies. Plants often process seafood from several different fisheries in an effort to keep their operations going. But natural flucuations in fishing conditions make this difficult. Periodic shut-downs are common. As a result, employment levels tend to vary from season to season and from year to year.

The amount of seafood which can be processed by hand depends upon the skill and effort of the individual worker. Because of this many workers engaged in hand processing operations are compensated on the basis of the amount they process. It is a common industry practice, for example, to pay those workers who peel, pick, head and shuck shellfish by hand on this basis. Also, many workers who fillet fish by hand are paid based upon how much they produce.

These circumstances prompt workers to move from plant to plant depending upon market and fishery conditions. Many workers also view seafood processing as a part-time job and come and go at will. As a result, it is not uncommon for a small facility with only a few jobs to rely on a large number of individuals during the course of a year. Recordkeeping can be burdensome on small companies particularly when large numbers of individuals work for brief and intermittment periods but are viewed as employees.

The Federal tax law has been modified to treat individuals such as these seafood processing workers as independent contractors. Congress, for example, has established independent contractor status for workers who are compensated based on the goods they produce (tenant farmers and fishermen) and for workers who migrate on a seasonal basis and work for intermittent periods (agricultural workers).

For these reasons, it would be appropriate to extend the same independent contractor status to those seafood processing workers who are paid based on the amount of seafood they process. S. 1821 would accomplish this and we urge you to approve it.

MR. ERICH BLOCH

DIRECTOR

NATIONAL SCIENCE FOUNDATION

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

FINANCE COMMITTEE

U.S. SENATE

July 12, 1988

Thank you for this opportunity to present the views of the National Science Foundation on the proposed Research and Experimental Credit and Reform Act, S.2484. We are delighted to provide them, for S.2484 seems to us legislation of exceptional merit. Its sponsors, especially Senators Baucus and Danforth, deserve high credit.

I am aware, however, that the fiscal realities of our stringent budget environment make it difficult for the Committee to approve proposals that are not revenue neutral. Therefore, while I strongly support passage of S.2484, I understand that we may not be able to achieve restructuring and permanent extension of the R&D tax credit immediately. If approval of the major improvements to the R&D tax credit offered by S.2484 is presently unattainable, I urge the Committee, at least, to pass a simple short-term extension of the credit as is and to consider passage of this proposal at the earliest possible time in the next Congress.

The National Science Foundation enthusiastically supports S.2484 on two grounds. First, the bill would make permanent the R&D tax credit, which we believe to be a primary instrument of effective national science and technology policy for a competitive world. Second, the bill would so markedly improve the structure of the credit as to increase by several times its effective incentive to conduct extra R&D.

Improved structure

When the R&D credit was initially enacted, Congress set out to limit the associated revenue loss by making the credit "incremental" -- allowing credit only for R&D that exceeds an established base. That way the rate of credit on the incremental R&D could be set much higher than would have been possible, given revenue constraints, had the credit applied to all R&D. Congress reasoned that most R&D within the base would have been undertaken anyway without any extra incentive. The goal was to provide a bigger incentive for companies to do more.

That reasoning was and remains sound. Unfortunately, in defining the base for the current credit a perverse counterincentive was inadvertently created. The same R&D that this year allows a company to claim credit over the next three years increases the base and so *reduces* the credit the company can claim. The net result is that real incentive for the company to invest in extra R&D is cut to a fraction of the nominal credit rate.

S.2484 would redefine the base to realize the original intent. A fixed base for each company would be increased by the percentage that gross national product has increased since the base years. Credit in subsequent years would be affected only by the company's R&D decisions and expenditures then. As a result, a company with R&D above the GNP-indexed base level really would get an incentive for increased R&D that corresponds with the nominal rate of the credit. Attached to my statement is an example that illustrates the difference.

This is the big improvement S.2484 makes over current law. But there are others. The redefined base would allow credit only for *real* growth in R&D spending, not growth that merely reflects inflation. An alternative reduced credit on a lower base would permit more firms to qualify for some extra incentive to increase R&D. Moreover, a new firm or an established firm entering a new market would for the first time be eligible for the credit. Major innovations often arise from small startup firms or new lines of business.

The Treasury Department estimates, we understand, that if S.2484 were modified to maintain strict revenue neutrality, the incentive effect on a "marginal" dollar of R&D expenditure would still be five times that of current law. This corresponds almost exactly with estimates made at our request in 1985. Examining only the proposed shift from the current "rolling base" to an "indexed base", economists funded by NSF estimated a fourfold improvement in the incentive effect. Further structural improvements in the Baucus-Danforth proposal would likely raise this estimated improvement to about the same five-fold increase that Treasury's experts anticipate.

No one knows for sure how much a fivefold increase in incentive effect would increase the extra R&D the credit induces. However, the doubling or tripling predicted by several experts seems reasonable to us. I know of no offsetting cost to the public interest, nor any dissent among economists and tax experts who have studied the R&D credit from a now mature consensus that S.2484 would for this reason represent a major improvement over current law.

The National Science Foundation has favored such an improvement in the credit structure for several years. As you know, it now has the official support of the Executive Branch generally. We wholeheartedly endorse the thorough analysis and excellent testimony provided to your Committee by the Treasury and by the Small Business Administration. We join them too in accepting disallowance of R&E expenses to the extent of the credit as a way of restoring in S.2484 revenue neutrality with respect to current law -- but also in *strongly* opposing such a disallowance in connection with any simple extension of current law. In that context such a disallowance would not only reduce the Government's commitment to increased investment in R&D, but eviscerate the already low incentive effect of the current credit, possibly below the threshold where it can be effective. I believe that would take us in just the wrong direction for the country.

Value of a permanent credit

The greatly improved structure and incentive effect of the credit under S.2484 redoubles our enthusiasm and reinvigorates the rationale for an R&D tax credit. Such a credit is one of the basic instruments of a sound national science and technology policy.

Individual private firms, and therefore the private economy generally, tend to significantly underinvest in R&D. When a firm invests in new plant or equipment, normally it alone among producers reaps the economic benefit from that investment. But not so with R&D. Knowledge does not stay put. When a firm invests in R&D, therefore, it can seldom keep the results to itself for more than a limited period. In some cases it may not even try to keep them to itself. So the benefits of the R&D investment are shared with other producers.

Moreover, a firm normally has a fairly secure expectation of how new plant or equipment will be used and will benefit the firm's business. A firm that invests in research, however, cannot be sure what, if anything, will be learned; how, if at all, what is learned can be applied; or who, if anyone, will benefit from the applications. The firm does have some notion of potential benefit, of course, and the narrower the scope of the research, the narrower the uncertainty. But always there are surprises, and often major ones. This unpredictability of results and benefits and the resulting risks are another reason why individual firms tend to underinvest in research.

For these and related reasons it is now widely accepted that Government should act to increase investment in R&D. One way in which we do that is through direct Government funding of research, such as is provided by the National Science Foundation. This has numerous advantages, particularly with basic research. But it also has some disadvantages.

Government officials are removed from and inexperienced with marketing and production in particular markets and industries. They are also removed from the incentives and discipline of the market, and so may undertake or persist with lines of development that those subject to a stricter economic discipline would have eschewed or abandoned. This is where the R&D credit comes in. It reduces the cost of R&D and so helps to redress underinvestment in R&D. Yet it leaves industry and the market to determine, without Government, what R&D will be pursued.

If our nation is to regain its competitive leadership, we cannot continue trailing our chief competitors in commercial investment and commercial R&D, as we have been doing. The U.S. has not kept up in commercial R&D with those who are pressing us for world economic leadership. (See attached chart.) An effective R&D credit will help correct that dangerous state of affairs.

I fully recognize, as must all who are involved these days with Federal budget-making, that budget stringencies force hard choices. But for me this particular choice is obvious. Whether we are able to make the decision now, or must postpone action until the next Congress, I firmly believe this course of action is correct and will play a vital role in ensuring our economic growth. Perhaps the major vice of Federal deficits is that they cut into productive investment in our economy, of which investment in R&D is particularly crucial. To cut back or eliminate the R&D tax credit would exacerbate the investment shortfall, not help solve it. The right thing for the country is to make this credit permanent. We have every confidence that Congress will find a way to do so.

R&E CREDIT BASE REDEFINITION
ILLUSTRATIVE EXAMPLE

A U.S. company has steadily growing R&D expenditures. Its R&D for the current year would exceed its base under either the current credit structure or the proposed modified structure. The company's VP for R&D now proposes to its CEO an extra research project that will cost $12 million in the current year, but will require no expenditures in later years.

Congress originally intended that the real cost of such an extra R&D project should be cut by the rate of the credit. As illustrated in the table below, in the first year that happens under either structure. But under the current structure the extra R&D also increases the company's base for each of the succeeding three years, reducing the credit the company gets in those years on other R&D. The cumulative result is a wash. The company does get use of the credit dollars for an average of two years. This provides some incentive to invest in extra R&D, but only about 2-3% before tax.

The analysis is different on different facts about the extra R&D -- for example, if the company were to keep spending an extra $12 million per year indefinitely -- but the bottom line is the same. The incentive amounts to only 3% a year.

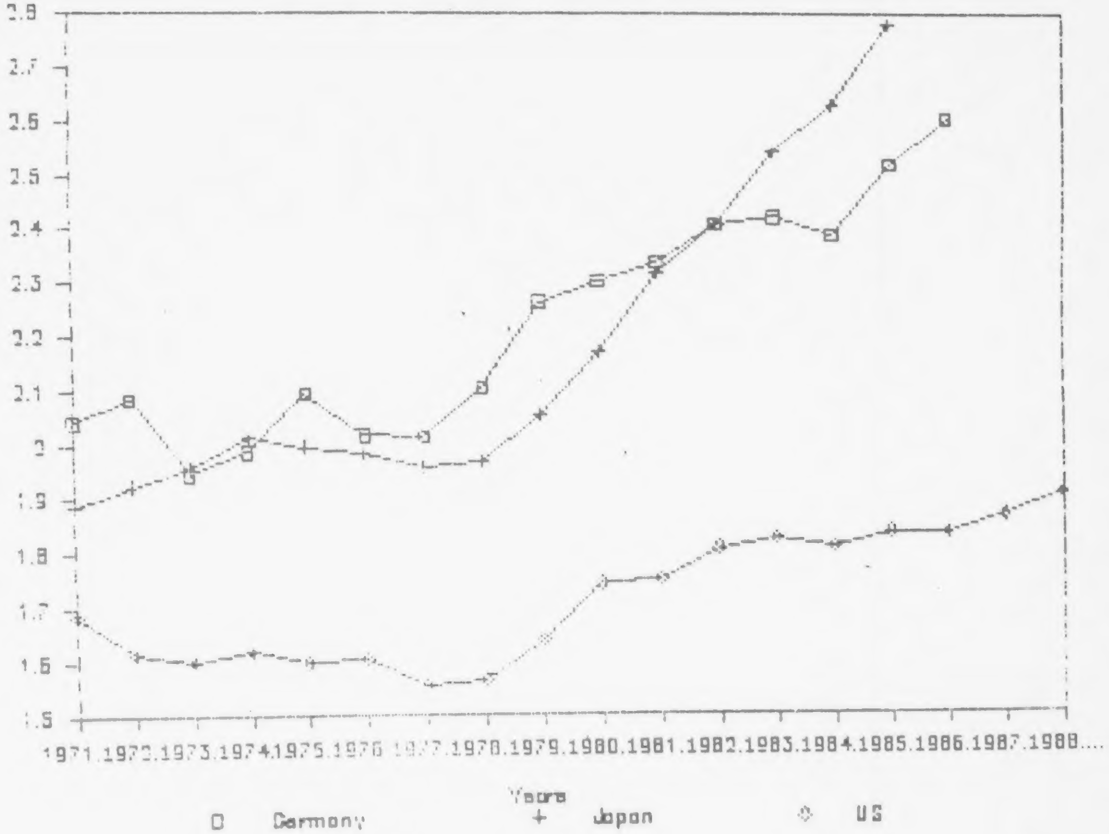
The proposed modified structure achieves the original intent -- it cuts the cost of extra R&D by the full rate of the credit. There are refinements and other improvements -- for example, to make startup firms eligible -- but this is the key improvement.

Current Structure (Rolling Base)

YEAR	BEFORE TAX COST	TAX EFFECT	AFTER TAX COST
1	$12,000,000	$2,400,000	$9,600,000
2	$0	($800,000)	$800,000
3	$0	($800,000)	$800,000
4	$0	($800,000)	$800,000
5	$0	$0	$0
Cumulative	$12,000,000	($0)	$12,000,000

Proposed Structure (Indexed Fixed Base)

YEAR	BEFORE TAX COST	TAX EFFECT	AFTER TAX COST
1	$12,000,000	$1,800,000	$10,200,000
2	$0	$0	$0
3	$0	$0	$0
4	$0	$0	$0
5	$0	$0	$0
Cumulative	$12,000,000	$1,800,000	$10,200,000



Nondefense R&D per GNP

National
ScreenPrinters, inc.

475 N. DEAN ROAD / P.O. BOX 2581
AUBURN, ALABAMA 36830

July 15, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committe's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

National ScreenPrinters, Inc. is a small locally owned corporation with approximately 44 employees, founded in 1962. Over the years since we started this company it has been my dream to have a plan that would give the people who are responsible for the success of the company a share in its ownership.

In 1973 we attempted to take a step in this direction by offering employees stock at 75% of book value, but soon learned that the legalities were so involved it was not practical and we were forced to withdraw the offer.

When we heard of the ESOP we were very interested, and after checking it out we adopted it three years ago. Since then we have experienced a better response on the part of all employees with regards to their attitude towards quality, attention to detail, service and being careful to avoid waste. The company is growing dramatically.

For all these reasons we feel very strongly that there is no reason to add the bureaucracy of Government control by requiring a majority of employees to approve the establishment of an ESOP, as required by the Armstrong ESOP Bill (S.2078). When 80% of the ownership of capital in the U.S. is in the hands of 10% of the people, our capitalistic system cannot compete with the Japanese. We must spread the ownership, and this is what teh ESOP does. If it becomes necessary to require employees to vote on the ESOP it will be extremely difficult to explain it to them, and chances are, human nature being what it is, they will vote against it simply because they do not understand it. Additionally, another layer of bureaucracy will be required to look after the requirements of the law. Do not encumber this wonderful tool our country has for competing in the world market.

Respectfully,

C. H. McGehee, President

Enclosures:

cc: Mr. Ed Mihalski

Attorneys
Henry J. Sockbeson
Faith R. Roessel (Member of
New Mexico bar,
application to the District
of Columbia pending)

Native American Rights Fund
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Executive Director
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July 11, 1988

Ms. Laura Wilcox
Hearing Administrator
United States Senate
Committee on Finance
Room SD - 205
Dirksen Senate Office Building
Washington, D.C. 20510

Re: H.R. 2792

Dear Ms. Wilcox:

Even though the Senate Finance Committe turned down our request to present oral testimony on H.R. 2792 at the hearing scheduled for July 12, 1988, before the Committee, we would like to present the enclosed written testimony for the record.

We ask also that the Committee ask the witnesses who have been selected to testify the following questions which will illuminate issues of common concern to all the treaty fishing tribes, but which are especially important to the treaty Tribes in Michigan. The questions relate to the limitations placed on individual and corporate ownership of treaty-fishing related activities. Ideally, they should be asked of a witness from the Department of the Treasury or the Internal Revenue Service, but could be asked of any witness.

In Michigan, three tribes hold fishing rights under one treaty in the same fishery. For purposes of the questions, we can call these Tribes A, B, & C.

Question 1: Often fishers from Tribes A and B, both holding commercial licenses, fish together as equal partners or one (fisher B) will be a helper to the boat owner (fisher A), in which case the cut would be 75%-25%.

What is the tax consequence to fishers A & B if they divide the net income equally? Is all the income for each non-taxable on the theory that they each caught only their own fish? Or is only half of it not taxable on the theory that half of each fisher's income was derived from the other's fish?

What allocation rules apply, if any, if the split is 75%-25%? Recall that each fisherman has a full treaty right to fish in that location.

Question 2: Treaty fisher from Tribe A owns a boat and fishes with treaty fisher from Tribe B and they hire a helper at the loading dock from Tribe B. What is the tax consequence to the income of dockside helper?

What are the tax consequences to the dockside helper in this question if he is from Tribe C? Remember, fishers from Tribes A, B & C all share the same fishing rights.

Question 3: Treaty fishers from Tribes A, B & C pool their resources to process and market fish caught from the treaty fishery. They hire workers from the three Tribes. What is the tax consequence to the wages of the workers? What allocation rules apply?

Question 4: Only fishers from Tribes A and B can afford to get involved in processing, but fishers from Tribe C sell their fish to A and B's processing plant with the result that one-third of the fish processed are from Tribe C. What is the tax consequence to the processor?

Under the bill, the processors will lose their protected status entirely if C's fish amounts to more than 10% of what they process or if members of C's Tribe do not own at least 10% of the equity interests in the processing plant.

Question 5: Assume facts in Question 4 but add that the plant employs members of Tribe C. What is the tax consequence to wages paid to employees who are members of Tribe C? Is C's income protected to the extent it is derived from fish caught by members of Tribe C? Or is it fully taxable on the theory that the employer is not a qualified entity in any respect?

The answers to these questions go to the heart of our request to present live testimony. These questions address existing or contemplated fishing activities and intertribal relationships in Michigan. They only hint at the inequities that will result under the complex allocations this bill will require. We believe that the answer to each question is that there is 100% tax immunity, because members of the three Tribes A, B & C all share the same fishing rights under the same treaty. Under the bill, however, the tax consequences will depend on which treaty fisher caught the fish and what portion of the fishing operation is owned by members of each tribe.

The last question I would ask is this:

Question 6: If an amendment were proposed to draw lines between treaties rather than between tribes so that all the tribes and their members who have rights under the same treaty could combine efforts in any way and still retain 100% tax immunity, would you be in favor of such an amendment?

Thank you for your assistance in this matter.

Sincerely,

Jerilyn DeCoteau

Jerilyn DeCoteau

JD/mdw
cc: Clinton Parish
Chippewa-Ottawa Treaty Fishery
Management Authority
Daniel T. Green
William Rastetter

TESTIMONY OF THE NATIVE AMERICAN RIGHTS FUND
ON BEHALF OF
THE CHIPPEWA-OTTAWA TREATY FISHERY MANAGEMENT AUTHORITY,
KENNETH TEEPLE AND DONALD ANTHONY
IN SUPPORT OF H.R. 2792

* * *

JULY 12, 1988

* * *

BEFORE THE UNITED STATES SENATE
COMMITTEE ON FINANCE

Introduction

Chairman Bentsen, members of the Committee, my name is Jerilyn DeCoteau. I am a staff attorney at the Native American Rights Fund, which represents Indian tribes, organizations and individuals on issues of major significance to Indian people throughout the nation.

This testimony is presented in support of H.R. 2792, a bill that would recognize that income earned by tribal fishermen exercising fishing rights guaranteed by treaty, statute or executive order is not taxable under state or federal laws.

I offer this testimony on behalf of the Chippewa-Ottawa Treaty Fishery Management Authority, whose member tribes include the Bay Mills Indian Community, the Sault Ste. Marie Tribe of Chippewa Indians, and the Grand Traverse Band of Ottawa and Chippewa Indians, and on behalf of Kenneth and Linda Teeple, tribal fishers from the Bay Mills Indian Community, and Donald Anthony, a tribal fisher from the Sault Ste. Marie Tribe. The Chippewa-Ottawa Treaty Fishery Management Authority was established in 1980 to protect manage the treaty fishery on behalf of its member tribes. The Teeples and Mr. Anthony exercise commercial fishing rights reserved under 19th century treaties. Mr. Anthony derives his entire livelihood from his fishing activities carried on from his 16 foot boat. The Teeples supplement their income by fishing part-time from their 16 foot boat.

For the past eight years, these fishers and many others like them have been the subject of efforts by the Internal Revenue Service to impose federal income taxes on income derived directly from the exercise of treaty reserved fishing rights. The Teeples and Mr. Anthony have cases pending in the United States Tax Court challenging the imposition of federal income taxes. The Teeples also have a case pending in the federal district court raising the same issue. These and other Michigan treaty commercial fishers are being subjected to state income taxation on this income as well. Some treaty fishermen have lost their fishing equipment and homes to the IRS and Michigan Department of Revenue.

While they support this bill, the Michigan tribes and individual fishers have some concerns about certain limitations in the bill and would like to draw this Committee's attention to two of the limitations.

Relationship of Section to Treaties

The language proposed in the section of the bill "Relationship of Section to Treaties" purports to be the sole source of exclusion from taxation for treaty-reserved fishing rights:

> Provisions securing any fishing right for any Indian tribe in any treaty, law or Executive Order shall not be construed to provide an exemption from any tax imposed by this title.

This language could be viewed as an abrogation of treaty-reserved fishing rights and does violence to the trust relationship and the Reserved Rights Doctrine, two cornerstones of Indian law. In considering the possible effects of this language, it is important to keep in mind the nature of treaties with Indian tribes.

Under the Supremacy Clause, treaties are superior to any conflicting state laws or constitutional provisions. Treaties with Indian tribes are accorded the same dignity as that given to treaties with foreign nations. Treaties with Indian tribes differ from foreign treaties, however, in at least two important ways: 1) treaties with Indian tribes are construed in favor of Indians; and 2) treaties cannot be abrogated by later treaties or legislation unless there is a clear and specific showing that abrogation was intended. Menominee Tribe v. United States, 391 U.S. 404 (1968). These rules are based upon the trust relationship with Indian tribes. Cohen, Handbook of Federal Indian Law, 62-63 (1982 ed.). All federal agencies, including the Internal Revenue Service, share the federal trust responsibility to protect the Tribes' treaty-reserved rights.

Because of the trust relationship and the inequal bargaining power of tribes in negotiating with the United States, treaties are viewed as a grant to the United States from Indian tribes of rights not reserved by the tribes. United States v. Winans, 198 U.S. 371, 381 (1905). Thus, the tribes reserved land to live on (reservations), water to meet reservation needs, and larger areas to use for usual activities such as hunting and fishing. The Reserved Rights Doctrine has become a fundamental of Indian law that is indispensable to the trust relationship and to fulfilling the goal of Indian self-determination espoused by this administration. See American Indian Policy Statement issued by President Reagan on January 23, 1983.

Because treaties are the supreme law of the land, no burden can be placed on any right reserved by treaty unless Congress indicates its clear and unambigious intent to abrogate such treaty. Thus, no tax law, by itself, can be deemed applicable to treaty-reserved rights. Conversely, it is not necessary for such laws to grant or provide an exemption from taxation for treaty reserved rights. For years, the IRS seemed to understand this and did not impose taxes on treaty fishing income. Since 1980, however, the IRS has changed its view. The resulting controversy has made this bill necessary, but only to reaffirm and recognize that such exemption exists by virtue of a treaty-reserved right. This bill has been a treaty clarification measure form its first introduction in the Senate as S. 727. The House Committee on Interior and Insular Affairs treated it as such. The Department of the Interior has been clear that taxes constitute an unlawful diminishment of treaty-reserved fishing rights.

The language in this bill would turn this legislation into a special interest tax exemption. It would significantly alter the Reserved Rights Doctrine by failing to recognize a reservation of rights and could result in an outright violation of treaty-reserved rights by limiting any exemption from taxation for such rights to that provided for in the tax laws. Such "reserved rights" cannot be limited, diminished or altered in any way without clear and specific congressional intent to do so.

States will certainly seize upon the sole source of exclusion language and rely on it to impose state burdens on treaty-reserved rights because to do so would not be viewed as diminishment of any treaty-reserved right. By virtue of the Supremacy Clause, treaties and federal statutes preempt state laws. Worcester v. Georgia, 31 U.S. (6 Pet. 515 (1832). The rule is that unless Congress authorizes the tax, a state cannot impose its taxes on Indians, their property or their business activities on their reservations. Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973); McClanahan v. Arizona, 411 U.S. 164 (1973). This rule applies with greater force to the exercise of treaty-reserved rights. Yet, as we have seen, states continually ignore or invent ways to get around the law and attempt to impose every manner of burden on treaty-reserved fishing rights from regulation to taxation to outright denial of such rights. See Tulee v. Washington, 315 U.S. 681 (1942). At this time, the State of Michigan continues to assess and enforce collection of income taxes on income earned in the exercise of treaty fishing rights.

In order to avoid any possibility of abrogation or diminishment of treaty rights and to be consistent with the Reserved Rights Doctrine and the trust responsibility, we urge this Committee to amend the offending language to read:

> The provisions of any law, Executive Order, or treaty which secures any fishing right for any Indian tribe shall not be construed to provide an exemption from any tax imposed by this title which is any broader than the exemption recognized by this section.

Rules For Individual And Corporate Ownership

These provisions are especially troublesome for Michigan treaty fishers. These provisions draw artificial lines between tribes that did not exist historically and serve only to discourage efforts of tribes and individual fishers from different tribes to work together to gain maximum economic benefit from the exercise of their treaty-reserved fishing rights.

In considering these provisions, it is important to remember that many tribes share the same fishing areas under the same treaty. For example, in Michigan, three federally-recognized tribes, the Bay Mills Indian Community, the Sault Ste. Marie Tribe of Chippewa Indians and the Grand Traverse Band of Ottawa and Chippewa Indians, all hold fishing rights under the Treaty of Washington, March 28, 1836, in Lake Huron, Lake Superior and Lake Michigan. Thus, there is one treaty, one fishery and three tribes. It does not make sense to limit the ways in which these Tribes or the fishers from these Tribes can combine efforts to gain improved economic benefit from the tribal fishery. Such limits did not exist at the time of the treaty, nor do they exist now. Presently, in Michigan, fishers from different treaty tribes fish together on the same boat, as partners, or employ each other as helpers. This is all highly regulated by the Tribes and no one can fish without a license commercially or for subsistence. Currently, fishers from the three treaty Tribes are working to establish a fishery marketing cooperative that will enable them to market their fish more effectively. The Tribes are also looking forward to establishing a tribal processing plant. Individually, the Tribes and the fishermen lack the resources or expertise to develop the fishery. Tax immunity would provide economic incentives for their combined efforts. The fear, if there is one, that these Tribes or individual fishers will become wealthy or that some fishing czar will emerge if these provisions are not applied seems unfounded. A look at the economic condition of the tribal fishery and the Tribes themselves should lay this fear to rest.

The State of Michigan produces 85% of the whitefish supply in this country. Over 50% of that is produced by the tribal fishery. Yet, the tribal fishery remains economically very weak for many reasons including low prices during peak production, lack of capital, equipment and management capabilities. Tribal communities, heavily dependent on the fishery, are generally impoverished, with unemployment of 40-60% depending on fishing seasons. For example, Bay Mills has 500-600 tribal members. In 1987, the Tribe had issued 63 commercial licenses and 10 helper licenses. Helpers are commercially licensed fishers who do not own their own boats. Another 50 subsistence fishing licenses were issued. Of 63 commercial boats, only 3 were large boat operations (over 25 feet), one of which was a trap net operation. All of the small boat operations (under 25 feet, 2 person maximum) were gill net operations. The average gross income of these fishermen is $12,000 to $15,000. This information was provided by the Bay Mills Tribal Administrator.

Among the three treaty Tribes in 1987, 265 commercial licenses were issued. Approximately 110 boats were operated, of which approximately 34 were large boats (over 25 feet) and the remainder were small boats. The total catch in 1987 was 6,546,363 lbs. for 14 species. The dockside value was

$4,504,626. Expenses amount to about 75% of production. The source of this information is Dr. William Eger of the Chippewa-Ottawa Treaty Fishery Management Authority.

It is interesting to note that the Select Revenue Measures Subcommittee of the House and Ways Committee reported that revenue loss to the federal treasury will amount to $8 million annually through 1992. The House Ways and Means Committee Report adopted this figure. H.R. Rep. No. ___, 100th Cong., 2d Sess. 1 (1988). Where this figure comes from remains a mystery.

These provisions will discourage tribal fishers and the Tribes themselves from combining efforts and risking loss of their tax immunity. Some fishermen have already been devastated by federal and state taxes. One treaty fisher was required to pay $700/month from his household income of $1200/month for back federal taxes on his fishing income. Others have lost equipment and have been threatened with the loss of even their homes. These provisions may provide enough financial disincentive to prevent any cooperative efforts for fear of overburdening the already shaky fishery economy, and it will certainly frustrate any existing intertribal relationships or plans.

The production of fish from the Great Lakes is a difficult and dangerous task, but it is vital to these Tribes as it was at the time of the treaty. It generates income for the impoverished Indian communities. It is a source of community pride and feelings of individual self worth. It reinforces the social fabric of the tribal communities, which like the fishing families, are in a struggle for survival in an increasingly competitive world. These Indians should not be denied the opportunity to compete fully and achieve self-sufficiency through the vehicle of this bill.

Alternatives

This bill should not place undue burdens on individual or combined efforts by treaty fishers to enhance the economic viability of their fishery by drawing artificial lines between tribes who share the same fishery under the same treaty. The bill, as written, would frustrate the policy of self-determination endorsed and reaffirmed by this administration.

If lines must be drawn, we suggest drawing them between treaties. Such an approach would do no violence to the treaty-reserved right because it would fit with what was historically and is presently the case, with respect to the Michigan tribes and I believe with respect to other tribes holding treaty-reserved fishing rights as well.

Thank you for the opportunity to present my views on behalf of the Michigan tribal fishers.

STATEMENT OF ROBERT W. LINN
DIRECTOR OF THE OFFICE OF MUNICIPAL LABOR RELATIONS
THE CITY OF NEW YORK
TO
THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE COMMITTEE ON FINANCE
H.R. 1961
THE PENSION PORTABILITY ACT OF 1988
AND THE ROLLOVER OF ASSETS
OF
AN ELIGIBLE DEFERRED COMPENSATION PLAN
OF STATE OR LOCAL GOVERNMENTS

JULY 25, 1988

I am Robert W. Linn, the director of the New York City Office of Municipal Labor Relations. I am submitting this statement on behalf of the City of New York to address one aspect of the issue of portability of retirement benefits which we believe should be addressed in any legislation to improve portability.

The City of New York urges the Subcommittee to include in any recommendations on portability a provision which would allow participants in an eligible deferred compensation plan under section 457 of the Internal Revenue Code (a section 457 plan) to rollover their plan balances to an individual retirement account (IRA), qualified plan, or other portability vehicle, as in H.R. 1992 sponsored by Congressman Rangel.

Section 457 encourages employees of state and local governments to save for their retirement. However, it is unlikely that any portion of those savings will remain for retirement planning without the availability of an IRA or other portability vehicle if the employee leaves governmental service prior to retirement.

We therefore recommend that when an employee separates from service he be allowed to elect to have the entire balance of his 457 plan account rolled over on substantially the same terms as other forms of retirement benefits. Although the Internal Revenue Code currently permits a rollover of distributions from one 457 plan to another 457 plan, many employees leave government service to become employed in the private sector. None of those employees has the option of rolling their 457 benefits over into another type of plan. In addition, many 457 plans require former employees to take their distributions on separation from service. They are not permitted to defer the distribution until retirement.

Allowing such a rollover has benefits for both the employee and the state or local government. The employee would be able to retain close control over the fund even after he has is no longer working for the government, and may not even be in the same locality. He also would be better able to integrate the assets of the 457 plan into his retirement strategy. The government would be relieved of the burden of administering the assets and keeping track of the former employee so as to be able to inform him of changes in the plan and send distributions to him.

Eligible deferred compensation plans are, at least in part, another form of retirement plan. The changes made in the Tax Reform Act of 1986 brought the 457 plans closer to qualified plans. Legislation which allows portability of the assets of other forms of retirement benefits should include the assets of 457 plans.

Under current law, an employee of a state or local government can agree to defer compensation, up to certain limits, under an eligible Section 457 plan. Although the employee does not have any right to the deferred compensation, or the earnings on the compensation (because such amounts remain assets of the government), the governmental unit generally maintains a funded account for the employee and lets the employee direct the investment of the funds. The amounts in the funds equals the amount of compensation the employee has agreed to defer plus the earnings on that deferral. The employee is not taxed on the deferred compensation, or the earnings, until it is made available to him or her. No employer contributions are made to an eligible Section 457 plan.

The funds may not be distributed earlier than when the employee separates from service, is faced with an unforeseeable emergency, or reaches age 70 1/2. The distribution must meet the minimum distribution requirements of section 401(a)(9) of the Internal Revenue Code and if periodic payments are made, they must be in substantially nonincreasing amounts.

The contributions and earnings in a 457 plan are employee contributions which have not been taxed. As a result, the objections usually raised to rollovers of after-tax employee contributions do not apply. There would be no need to keep track of the amounts rolled over separately since the entire amount of these benefits would be taxable on distribution.

Qualified plans and IRAs have, if anything, stricter standards for distributions and protection of spouses and other beneficiaries and do not allow distribution for unforeseeable emergencies. As a result, the rollover of amounts from a 457 plan to some other portability vehicle should be at the election of the participant. This would allow him to choose to subject these benefits to the additional requirements and loss of flexibility.

OREGON STEEL MILLS

P.O. Box 2760
Portland, Oregon 97208
Phone (503) 286-9651

July 20, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, D.C. 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Oregon Steel Mills, Inc. opposes the Armstrong ESOP bill which provides for additional regulations in the establishment of Employee Stock Ownership Plans. If enacted, the Armstrong ESOP bill would create another obstacle which would impede the development of employee ownership. Employee ownership at Oregon Steel Mills has succeeded in making a difference in keeping this Company competitive in the world markets. All employees have benefited and now have the advantages of substantial capital in addition to employment with a successful company. Formation of ESOP's should be encouraged, not discouraged by our government.

Sincerely,

V. Neil Fulton
Vice President

cc: Senator Bob Packwood
Chairman
U.S. Senate Committee on Finance
1317 Dirksen Bldg.
Washington, D.C. 20510

Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Hart Senate Office Bldg., Room SH 203
Washington, D.C. 20510

PEDERSON-SELLS EQUIPMENT CO., INC.

TELEPHONES: 515-573-8129
529 SOUTH 29TH STREET
FORT DODGE, IOWA 50501

July 18, 1988

Ms Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms Wilcox;

Pursuant to the Committee's request for testimony of S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Pederson-Sells Equipment Co., Inc. opposes the enactment of S.2078. Our Company recently adopted an ESOP due to the retirement of the former owner. This legislation if enacted prior to the adoption of our ESOP could have prohibited the Continuation of our Company and the employment of some 15 citizens.

Sincerely,
Pederson-Sells Equipment Co., Inc.

Gregory S. Jude

Gregory S. Jude
Treasurer

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

Piggly Wiggly Carolina Company
BOX 10447 RIVERS ANNEX·CHARLESTON, S. C. 29411

JOSEPH T. NEWTON III
PRESIDENT

July 14, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Rood SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Piggly Wiggly Carolina Company, Inc., and its' sister company, Greenbax Enterprises, Inc., and I, Vice-President and President respectively of these two companies, are very much opposed to the passage of the referenced bill. Three years ago these two companies jointly established an ESOP for the benefit of their employees and the future of these employees. Having had these three years of experience I would like to explain some of the reasons that I believe that the passage of S.2078 would be detrimental to the ESOP program and in the long run would be detrimental to employees to be benefited by future ESOP plans.

My reasons are as follows:

[1] It has been our experience that for employees to fully understand the significance to them of the ESOP program is to a large extent a function of time. In my companies we have undertaken an intensive educational program to help them understand what ESOP means to them. It has taken most of the three years, during which our plan has been in effect, for its' benefits to become fully clear and significant to our employees. As you know, for the most part ESOP plans grow at a fairly constant rate and in addition to the time it has taken to educate our employees time was required for them to fully understand how their interest in the company and their future will grow significantly from year to year. I feel that it would be all but impossible to achieve a level of understanding by employees in a short period prior to the adoption of an ESOP plan that would enable them to make a sensible decision when ask to approve or disapprove the establishment of an ESOP.

[2] Until the establishment of an ESOP plan our companies have been closely held family companies. The founder of our companies, who is now retired, but who still owns a majority of the outstanding stock is 75 years old. We know that we face, in the not too distant future, an extremely difficult problem with cash flow because of the severe liability for inheritance tax which must be discharged. The very important and extremely significant help that our ESOP plan will provide in facing this tax burden will help secure the future of the company. Certainly there can be no greater benefit to our employees than this. I feel that to be forced to discuss and explain this sort of future benefit to employees would be an impossible and from a management standpoint totally improper undertaking.

[3] It is difficult for me to conceive of how any ESOP plan can be established and fail to have in some way a beneficial effect on the company's employees. To require employee approval of such a plan seems to me to be a burdensome, unnecessary and superfluous requirement. It is difficult for me to understand why the members of our legislature continue to place obstacles in the way of what I perceive to have the potential to be one of the most important benefits to the workers of our country, to the economy of our country and to the productivity of our country.

Sincerely,

Burton R. Schools
President of Greenbax Enterprises, Inc.

Executive Vice-President of Piggly Wiggly Carolina Company, Inc.

jcs
cc Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

PLAN ADVISORS, INC.

Actuaries & Administrators - Pension & Profit Sharing Plans

HONEYWELL BUILDING P.O. BOX 302
BALA CYNWYD, PA. 19004-0302
(215) 667-8383

July 12, 1988

Ms. Laura Wilcox
Hearing Administrator
U. S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to Require a Majority of Employees to Approve the Establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

ESOP's are currently, at best, cumbersome to establish properly, but they are worth the effort. To be properly installed, they require substantial services from a knowledgeable attorney who specializes in pensions and subspecializes in ESOPS. If S.2078 is passed, substantial additional services will be required from an ESOP Attorney. An additional subspecialty of attorney will be required to advise companies on what is required and permitted during the communications phase before voting. Similar advice will be necessary for the balloting phase.

In addition, one or more ESOP consulting-administration firms will be necessary from the early planning stages through completion. If the administrative firm is not able to provide employee communications and assistance prior to establishment of the ESOP, an employee communications or public relations firm must be retained to advise the Company before the ESOP is in existence. After this type of legislation is in effect for a time, litigation attorneys will be needed to assist employees and stockholders who suffered damages as a result of the cumbersome, easily subverted operation of this new set of procedures.

We believe there is little or no ERISA preemption in the effects of all or most of the securities laws of the 50 states.

Passage of S.2078 will certainly result in an expanded library of regulations from "Treasury" and "Labor", temporary, proposed and in "notice" form before final regulations are issued with little change. SEC and perhaps other federal agency regulations will, if not immediately, soon be needed. Additional IRS, DOL, SEC, etc., recordkeeping, reporting and record-retention requirements will be necessary. Perhaps the NLRB will be involved to aid in regulation and enforcement. The SEC must be called upon to regulate some aspects of some companies' pre-ballot communications and "advertising". Far fewer companies will decide that an ESOP is worth the effort and expense.

The companies that will succeed in finally establishing ESOP's will be those that are willing or able to spend additional time and money to "slosh" through the process. The smaller, creative, efficient, high-potential companies with motivated workforces which will be successful on an increasingly competitive international scale will more often reject ESOP's during the stages when employees participating in ESOP's normally reap the greatest rewards.

Companies with counter-productive and/or abusive motivation for establishing ESOP's will be some of the most successful at the employee ballot-box. In many companies, the conditions for employee voting or opinion manipulation are ideal. Some ESOP's in hostile takeovers have been abused. In many cases, the voting rights were tools of abuse.

Participation in and contribution to a company's progress are not directly related to an employee's right to vote in corporate decisions. Successful companies are rarely built in the style of participatory democracies. The most successful elements of the leading management methods are those that encourage and receive employee participation and contribution in areas that employees know better than their managers. Other forms of participation such as "voting" is often either counter-productive or manipulated by skillfully designed "communication" programs.

ESOP growth is recent. ESOP's are only recently receiving attention and study. Additional study and understanding are needed. Relevant existing legislation needs fine tuning. However, tax committees have been saddled with far more pressing demands. The result is that ESOP's, especially their potential as a needed contribution to the U.S. economy, have not been explored by Congress. Not even a fraction of the time and appropriate resources have been allocated to their study. Tax committees should not be expected to reallocate already inadequate resources.

Creation of new bureaucracies and engorgement of existing ones is impairing our ability to reverse our national decline in economic and social progress.

This deceptive and seemingly minor addition to an already burdensome body of "Pension-ESOP" law would cause insidious damage when and where we can least afford it.

Sincerely,

President

CAL:mln

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

PROST BUILDERS, INC.
The 7th Generation

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July 12, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Statement for Committee's July 12 Hearing Record on S. 2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S. 2078 (Committee Press Release H-28), this letter and four copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We at Prost Bldrs. feel that if enacted, the Armstrong bill would create massive government regulations regarding the establishment of ESOPs and would seriously hamper the creation of new employee stock ownership plans. As you may or may not know, government regulations are now, and have been far too many year too extensive. The ESOPs as originally intended have a number of years of successful operations both for the good of management and labor. The bill would also require the Secretary of Treasury to issue unspecified voting rights regulations which again is involvement overkill.

Again, let me urge you to consider this as a bad bill having umdue concern for the betterment of the interest of your fellow workers and management alike.

Paul R Prost

Paul R. Prost, Pres.
PROST BUILDERS, INC.

cc's: Mr. Ed Mihalski

"LARGE ENOUGH TO ACCOMMODATE • SMALL ENOUGH TO APPRECIATE"

Rea Brothers, Inc.

PLUMBING CONTRACTORS
P.O. BOX 158 • PINEVILLE, N.C. 28134
PHONE 704-552-2272

July 11, 1988

Ms. Laura Wilcox
Hearing Administrator
U. S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

We, at Rea Brothers, Inc., think that ESOP's are a grand instrument, built to allow for a new surge of energy in our free enterprise system. We, therefore, strongly oppose any action that would complicate the process of establishing and maintaining an ESOP. Requiring a note of approval by company employee's as a prerequisite would not be in the best interest of those desireing to have an ESOP. We, therefore, wish to go on record in opposition to any such wording or action tying an employee vote to the installation of an ESOP.

Thank you for your hard work on our behalf and for considering our viewpoint.

Sincerely,

Ralph Rea
Company Executive - Sec.

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

RIETH-RILEY CONSTRUCTION CO., INC.

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28); this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

As an existing ESOP Company we wish to advise you that we do not favor the proposed legislation presented under S.2078 as offered by Mr. Armstrong. Our objections are set out below for your consideration.

An ESOT plan is designed as a retirement benefit for employees. Other retirement plans (defined benefit and defined contribution) do not require a "secret ballot" prior to enactment. This proposed requirement places an undue burden on the creation of an ESOT plan.

Notification to employees relative to "all of the material facts" prior to implementation of the ESOT plan could place company management in a precarious position relative to negotiating terms and conditions with third parties. Management is in the best position to determine the terms and conditions of any contractual conditions.

Our ESOT plan, as we suspect others do also, already provides for the future purchase of shares. These proposed amendments to the law may, by future administrative rulings unknown to us at this time, require changes which could be time-consuming, expensive, and unnecessary.

Basic voting rights are already extended to participants and beneficiaries as they relate to substitive changes in the ownership of the Company. These existing rights serve to give participants a voice in the basic changes in the corporate structure. The Trustee, by virtue of its position of trust and responsibility, should have the responsibility for all other voting matters. While we agree that voting rights should be substantially similar for similar classes of securities we do not believe that the voting thereon should be done by participants when the securities are under the responsibility of the Trustee.

The present laws relative to ESOT's provide adequate protection for all concerned. Abuses are always possible, however, it does not seem proper to place unnecessary laws on all to protect against the few. We strongly urge your Committee to reject proposed bill S.2078 and encourage, not discourage the continued growth of ESOT's as a viable alternative to retirement benefits and continued growth of the entrepreneurial spirit of America.

Sincerely,

RIETH-RILEY CONSTRUCTION CO., INC.

Larry L. Jones
Secretary & Treasurer, and
ESOP Committee Member

FISHER

Scallon Controls

July 12, 1988

Ms. Laura Wilcox, Hearing Administrator
U. S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Subject: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Scallon Controls, Inc. feels very strongly that S.2078 should not be approved. If enacted, it would significantly increase the paperwork required of small businesses like ourselves, and would seriously hamper the creation of new employee stock ownership plans. Our ESOP plan has been an unqualified success in establishing ownership throughout the organization. I would hate to see other companies and employees denied this opportunity because of increased government regulations.

These proposed regulations are attempting to solve a problem encountered in only a few ESOP formation situations. Regulations such as proposed in S.2078 are analogous to "throwing the baby out with the bath water".

Sincerely,

Glen Nieman

GLEN NIEMAN
President

GN/tll

cc: Mr. Ed Mihalski, Minority Chief of Staff

A Sales Representative of Fisher Controls

SCOT FORGE

James F. McKinley, Jr.
President

8001 Winn Rd.
Box 8, Spring Grove, IL 60081
312/587-1000
Outside Illinois 800/435-6621

July 11, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an Employee Stock Ownership Program, ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

I believe the enactment of Senator Armstrong's bill, #S.2078, would be catastrophic to all businesses that currently have or are anticipating the beginning of an Employee Stock Ownership Program.

SCOT FORGE is a privately held Company that believes in offering competitive wages and highly motivating Benefits Packages to its employees, but because we are a small company, we depend on programs like the ESOP to attract and keep dedicated employees.

Studies have shown that people, by nature, are not accustomed to coping with change, and therefore, will seldom allow for change to occur within their life. Change, in any program or situation, begets skepticism, and skepticism begets no allowance of change. By allowing Employees to vote on whether they should or should not have an ESOP would be, in effect, allowing a possible adverse change. This adverse change could in fact hinder the possibility of employees initiating an Employee Stock Ownership Program, thereby making it more difficult for our Company to attract and retain outstanding employees.

Ms. Laura Wilcox
July 11, 1988
Page 2

A second point regarding Senator Armstrong's bill is the allowance of substantially similar voting rights of the participants equal to that of the major stock holders and Board of Directors is an absurd and ridiculous idea. For example, Congress allows for its constituency to suggest approval and disapproval of legislative matters in the forms of PAC's and Lobbyists, they do not however, allow these committees to vote policy for them. Each Senator and Legislator were hired, if you will, to perform their own voting based on their constituencies wants and needs and will take into consideration the needs and desires of the lobbyists and PAC's.

It is my belief that the Board of Directors of a Company are hired much the same way as are Legislators and Senators. They are hired to make major decisions that affect the positive growth of an entire Company based on the employee's wants, needs and desires as are the Legislators and Senators that are hired to make the decisions that effect not only a constituency area, but the entire Country. Therefore, both groups (Board of Directors & Congress People) would need to have developed a high experience level that is germane to look at the entire Company and World picture. Unlike a Board Director or a Congress-Person, a single Political Action Committee, or a single stockholder, who would grasp only a microscopic view of an Organization and or piece of legislation that affects their biased basis of knowledge and ultimately, allowing for incomplete decision making that affects the Company / Country in its entirety.

In conclusion, I believe that the passing of Senator Armstrong's proposed bill #S.2078, would be detrimental to the quality and continuation of all Employee Stock Ownership Programs.

Sincerely,

SCOT FORGE COMPANY

James F McKinley Jr

James F. McKinely, Jr.
COO / President

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

JFM:ljh

SHORR PAPER PRODUCTS, INC.

July 13, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record
on S.2078, to require a majority of employees to
approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H028), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988, hearings.

We are writing to express our opposition to Bill S.2078. Thank you for your consideration.

Sincerely,

SHORR PAPER PRODUCTS, INC.

Kenneth Shorr

KS;jg
cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510

SOLAR PRESS

Solar Press, Inc.
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FAX 312 983 1095

July 15, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Statement for Committee's July 12 Hearing Record on S. 2078, to Require Majority of Employees to Approve the Establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S. 2078 (Committee Press Release H-28), this letter and four copies are sent to be included in the Committee's printed record of the July 12, 1988, hearings.

Solar Press has been an ESOP company since 1986. The company was completely owned by the Hudetz family prior to this date. Since its inception in 1972, my brothers and sister owned 100 percent of the common stock until sales to the ESOP began in 1986. The decision to install an ESOP in our fast growing and highly profitable business resulted from our experience of having more and more difficulty as a family passing our corporate culture and methods of customer service and production processes on to an ever increasing number of new employees.

As recently as 1981, our company was $2 million in sales and had less than 30 employees. When the ESOP was installed the company was approaching $25 million in sales and had close to 250 employees. We had a profit sharing plan in effect at that time which generated corporate contributions of approximately 5 percent of employee pay to our full-time employees.

In order for the company to consider what the family perceived as a threatening environment between employees and management, we had to examine closely why we should ever give up part of our stock to an employee of the company. Fears ran from loss of control in the stockholders' meeting, to rank and file employees questioning expense accounts, to inability by top management to make equipment purchase decisions or marketing decisions, and so on. It took education and many family meetings to show us the light and dispel these fears. We were not easily convinced to make the ESOP part of our company plan even though there were financial and tax benefits for us as a family and for the company as a whole.

Needless to say, we have been very pleased with our ESOP decision and have told our story to many different companies and media people (see the attached article in Inc. magazine, June 1988). We know that the results of installing this program will have a long-term positive effect on our workforce and on our competitive edge in the marketplace. It was, however, difficult for us to envision this two years ago when the program was first being installed.

We are a small company that has grown quickly into a medium-sized company. We have relied on our talents as a family along with sound advice from outside advisors to make sensitive corporate decisions in a logical way. The prospect of opening up our detailed discussions to the rank and file employees for their voting considerations would have turned us completely away from the idea of ESOPs from the start. As it was, it took six months of meetings and discussions amongst the 12 of us to come to the conclusion ourselves that this was a viable program and a meaningful one for our employees and our company as a whole.

The process of making this decision with 250 employees would have been nightmarish and impossible. We would have never installed the ESOP or recommended it to our employees with this prospect in mind. It would have been a great injustice to the employees to force this burden on them. They have even less opportunity than we do to read and absorb all the nuances of the ESOP laws and regulations. Most people's reactions would have been one of confusion and questioning of ulterior motives of the management installing this type of program. Therefore, it would have taken a great effort on our part to explain how this move was the best thing for the whole company.

After two years of operation with the ESOP in place and after continued reinforcement by management of the concept that we all are now employee-owners, it has become clear to the employees that our intentions and sincerity were heartfelt and real at the time we installed the program. But it must be admitted that it is rather hard to perceive management in this day and age as having such clear, democratic, and idealistic outlooks on how best to run a company in today's economy. We knew as a family that foregoing 25 percent of our ownership and placing it in the hands of the employees would allow the remaining 75 percent that we retained to grow at an even faster rate because of the new employee-owners' involvement. This has proven to be true. It was a bold, though measured, move on our part to inspire ownership feelings in the entire plant rather than in only the few entrepreneurs that owned and ran the business. If this bold and measured move had to be made by a group of 250 people rather than 12, I am afraid it would never have been made.

This country needs more competitive companies and competitive employee-owners as we have here at Solar Press. We need to pass the qualities of hard work and a feeling of satisfaction in a job well done or in a company environment that listens to every worker's voice along to the next generations. The idea has to start somewhere and it is our opinion that it needs to start in the minds and hearts of the current owners and entrepreneurs who lead our corporate world today. There is plenty of logic for them to listen in the social, economic, and moral underpinnings of the ESOP law as it exists today.

Making an ESOP decision is not an easy one for a business owner. I know from personal experience and from attending three year's of seminars on ESOPs and speaking at several of them to owners who are toying with this entire concept. They each seem to be struggling with a desire to do what they perceive as the right thing under the ESOP principles and with the fear of unknown which can be labeled "employee reaction." With this legislative proposal pending for the last year, I have made it point to ask as many business owners as possible whether they would make this decision if the requirements as enumerated under the current statement to your committee were required of them in advance. I have not found one owner who would proceed with his ESOP plans if he were required to seek majority approval. It seems to cut the owner in two different ways.

First of all, it requires the owner to make complete disclosure of every aspect of his thinking. This he would be willing to do if he had the time. I don't believe the motivation from people I have talked to is anything but for the good and future growth of their company but complete disclosure could cause enormous disruption and misunderstanding. Anyone who has run a major organization and changed the lunch period from 12 o'clock to 12:30 p.m. will know exactly what I am talking about.

Secondly, the decision to go ESOP is perceived by many owners, ourselves included, as truly a gift to the employees. It is not much of a gift or at least the gift giving feeling is diminished when the employees themselves have the right to refuse the gift or decide on how it will be selected or packaged.

I know that we as a family feel better and more like the givers that we truly intended to be having made the ESOP decision on our own and knowing full well that the employees will enjoy the gift more and more as the years go on. Having to argue with employees on how to structure and package the ESOP program would have probably left us cold and with a feeling that we might as well keep the ownership to ourselves rather than pass it out to the employees. I don't think these are unnatural feelings to have. They are real enough feelings for an owner to use them in the scale when weighing the potential impact of an ESOP-owned company against the hassles of passing ownership out to each and every eligible employee.

I hope our concerns on this matter are heard. I feel strongly that ESOPs are a necessary tool for this country to explore. I say this as a citizens and individual who is high on the American dream and one who would like to see that dream fairly and equitably spread amongst more of the population.

Thank you for your consideration.

Sincerely,

Joseph B. Hudetz
Vice President - Finance
and Legal Counsel

/cjb
Enclosure

cc: Mr. Ed Mihalski
Mr. Dennis Hastert

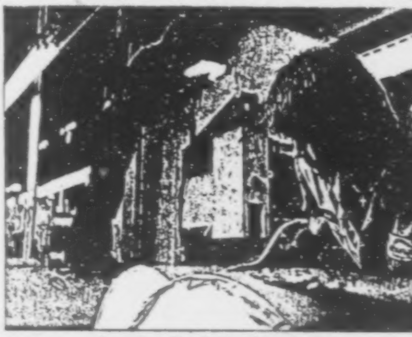
CASE STUDY

How one family business did it right

Clay Polk, 28, is a supervisor on the second mail-room shift at Solar Press Inc., and today he is complaining to management. The tools needed to fix a jammed machine, he says, are always getting lost. Work stops while the crew chiefs look for them.

This, it is plain, is not your ordinary workplace complaint. Polk is the leader of a group of four other hourly workers, and together they have researched their grievance to within an inch of its life. They know how often the machines jam up, how long it takes to find the tools, and how much the unnecessary downtime costs the company. And they have a proposal: buy the 17 mail-room crew chiefs individual sets of tools. Hand-lettered wall charts compare the cost of the new tools with the costs of the current situation. If management will pay for the tools, Polk says, his group will come in before work to build toolboxes and a depot to keep them in. And oh, yes: crew chiefs will replace any tools they lose.

Management—represented here by vice-president of finance and administration Joe Hudetz and mailing-department manager Chuck Ortinau—is convinced.



Supervisor Clay Polk of Solar Press Inc.

Employees are entrusted with information and responsibility.

When the plan proposed by Polk's group goes into effect, the annual savings could come to $8,000.

Not much for a $27-million business?

Maybe—but then this group is only one of 16 "creativity circles" established throughout Solar Press since January 1987, and all of the 16 groups are busy coming up with ideas to save money or improve quality. The customer-service reps realized that job tickets were being written up in a dozen different ways, leading to recurrent production foul-ups, and are writing a manual to standardize procedures. A pressroom circle figured out how to save thousands of dollars in wasted paper by opening the rolls differently.

All this, oddly enough, is part of Joe Hudetz's plan—a plan that began with wondering how he and his 10 brothers and sisters, owners of the company their father had started, could solve two problems.

The siblings' immediate concern was liquidity. Solar was highly profitable, but shares in the privately held company had no market.

For those active in the business—

BCM Engineers, boost the ownership message with regular cash dividends. "We pay them in the summertime, right around the Fourth of July," says BCM's Jablonski. "It really makes the ESOP mean something more than just a stock certificate."

☐ Participation in management. At BCM—and at other ESOP companies that pass voting rights through to employees—workers elect the board of directors, just as shareholders do in a public company. But participation need not be limited to elections, nor to the kind of consultation Bertuch has established with his committee. At Clay Equipment Corp., an Iowa manufacturer of farm equipment that installed an ESOP a few years ago, employees meet in groups to discuss ways of increasing sales, cutting costs, and improving products. At Phillips Paper Corp., a San Antonio distributor of packaging to the fast-food industry, employee committees make nearly all decisions relating to working conditions, benefits, equipment purchases, and sales policies.

The CEOs who treat employees as owners swear by their methods—which is not to say that those methods are appropriate for all. But at least some evidence points to an effect on company performance. A National Center for Employee Ownership study, for example, found that a sample of 45 companies grew faster after establishing an ESOP than they had been growing before, with sales rising fastest in high-participation companies. And a recent report by the U.S. General Accounting Office found a positive relationship between employee participation and corporate productivity, though no relationship between economic performance and ESOPs in general.

Information sharing, generous compensation schemes, participation in management—is it all a bit much? It was for Phil Grogran of Keyser Garment, who resented the fact that, as he put it, "There are certain individuals who think they own the plant and think they should run it." If you're in Grogan's camp—if you'd just as soon not rock the managerial boat—you may not want an ESOP.

But if you believe that a culture of cooperation is exactly what your business needs, you may well want to start with sharing ownership—and then learn to involve your employees in the operation of the company. The one without the other may give you some tax breaks, but it won't have any positive effect on the way your business works.

So far, so good—but aren't ESOPs expensive and complicated? And can't they backfire?

Yes, and yes.

First come the consultants, then the lawyers and accountants. A feasibility study alone can cost several thousand dollars. If you decide to proceed with the plan, you'll spend at least $15,000 to set it up. Once it is in operation, moreover, the law requires a complete annual valuation of the company, and someone on your staff will have to spend large amounts of time administering the plan. ESOPs are even more complex than other tax-qualified retirement plans—themselves no models of simplicity—because the relevant rules and regulations are still being written.

These administrative costs alone can blunt the attraction of an ESOP. "For small companies, the costs are really just too high," says Elliot Schrier of Manalytics, the San Francisco consulting firm. An ESOP isn't cost effective, experts agree, until the payroll is larger than 15 or 20. Similarly, if all you want is an employee benefit—and you don't particularly care about the tax and

PHOTOGRAPH: DAVID SUTTON

there are six Hudetz brothers running the company—the problem was managing Solar's explosive growth. As recently as 1980, the Naperville, Ill., company had about 30 employees and $2 million in sales. As business soared—and as the number of full-time workers passed 200—Solar began losing its family-run culture. In the past, the Hudetzes had known all the employees, and had worked out of offices right on the shop floor. Now there were too many people, and communication between managers and workers was breaking down.

Joe Hudetz isn't the chief executive; that job belongs to younger brother Frank, who has been with the company longer. But it was Joe, a lawyer and CPA, who introduced ESOPs to the rest. By 1986 Solar had established its plan.

The advantages were apparent immediately. The ESOP borrowed $4 million and passed the loan through to the company, which retired an equivalent amount of long-term debt. Since principal and interest on ESOP loans are tax-deductible, Solar saved some $150,000 a year. It contributed that money to the ESOP, which began buying family members' shares and allocating them to employees' accounts. Solar found it could contribute 15% of payroll to the ESOP—roughly triple what it had contributed to its old profit-sharing plan, and at no extra cost. At this rate, employees will own 25% of the business by 1996.

But Joe Hudetz had management on his mind as much as finance. "We wanted to reverse the trend toward top-down management," he says, "and get back to a group effort, the way it used to be." An ESOP alone, said the experts Hudetz consulted, wouldn't accomplish that goal. Employees had to be treated like owners, entrusted with information and responsibility; and they had to see some tangible results of their efforts now, not just at retirement.

Hudetz attacked on several fronts. He released the company's first-ever public financial report. He instituted a new gain-sharing system: 25% of all profits over a certain modest target would be distributed as "employee owner bonuses," typically adding several hundred dollars per quarter to veteran employees' paychecks. Most significantly, he established the creativity circles, thereby giving employees a chance to take control of their work lives.

To hear some employees tell it, all this was laid on a little thick. "I was skeptical," says Vince Adelman, a supervisor in the prepress department. "The idea was heavily sold and packaged; the leaders tried to elicit enthusiasm for it. I felt as if I were being manipulated." But, says Adelman, he became a reluctant convert. "What really convinced me was seeing that the system worked. For example, we had a problem with printing-plate rework. We gathered up data, charted it, and ended up reducing rework significantly."

From Hudetz's perspective, the ESOP and its accompanying changes have worked well as management tools: absenteeism and turnover are down, sales and profits up. "The company that we'll own 75% of will grow faster than the company we used to own 100% of," he predicts. But what impresses him most is the way employees now seem to be acting like owners, thinking about their jobs as well as performing them. "The American worker needs a shot in the arm to start being more competitive," he says, "and this gives it to them. They wake up in the morning saying, Hey, I'm somebody—I *own* a piece of this place."

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financial advantages—an ESOP may be overkill. "I could design a stock-option or some other kind of stock plan that would have all the motivational benefits of an ESOP and cost the company less," says Touche Ross's David Stone.

Administrative costs are at least predictable. But there's also a hidden—and unpredictable—cost to an ESOP. Consider: in an ESOP transaction like Bertuch's, the cash borrowed from the bank goes to buy out the owner. Employees get stock, not money. Yet the company or the ESOP must offer to buy back every departing employee's stock at current appraised value. So D.V.C. Industries will eventually be liable for cash outlays beyond what it pays the bank.

This repurchase liability, as it's known, operates by a kind of perverse logic. The faster D.V.C. grows, the more the stock will be worth and the more costly the buyouts. If the company runs into trouble the stock will be cheaper—but there may not be enough money to redeem it. Exactly when the bill will come due, moreover, isn't clear. In a small company, employee departures can't be predicted with precision.

The problem arises whether or not the plan is buying the original owner's shares. A company can contribute new shares to an ESOP, for example, and deduct their full value from its taxable earnings. That's a cash-generating benefit plan—but the company will need all these tax savings and a good bit more when employees leave. The situation is the same when a company borrows through its ESOP, as BCM Engineers has done. For every loan dollar that's repaid, the company must credit employee accounts with a dollar's worth of stock. That dilutes existing shareholdings and creates new repurchase liabilities. So the transaction makes financial sense only if the loan "buys" enough growth and profitability to cover its eventual costs.

It's possible to make more of the repurchase liability than it merits. The ESOP is, after all, a benefit plan, and benefit plans do cost money. Even so, some of the companies we talked with had gotten themselves into trouble on this score. A Honolulu entrepreneur, whose company has hit hard times, said he'd have to sell assets to buy out his key employees if they chose to leave. The bottom line? "You have this big uncertainty hanging out there," says Corey Rosen, of the National Center for Employee Ownership. "You're trading a present cash-flow benefit for a future liability of uncertain size."

How else can these plans get me in trouble? Seems to me a lot of ESOPs have wound up in court.

The administrative complexities of ESOPs—and the strict rules governing repurchase—reflect a fundamental tension in the conception of the plans. ESOPs provide all kinds of tax advantages. But they are benefit plans, not just tax shelters, and they're governed by many of the same restrictive laws that govern other tax-qualified deferred-compensation plans. In legal terms, they're expressly required to operate for the "exclusive benefit" of the participants.

That opens the door to plenty of disputes—over valuation, for example. Companies have always been required to assess ESOP stock at fair market value. But the objectivity (or competence) of the appraisers has sometimes been in question. The *U.S. News* case dramatized the potential for, let's say, different interpretations. In 1983, the magazine was appraised at $425 a share; when it was sold the following year, the price was $3,000 a share. Hard times can also cause disputes. When a company goes

SOVRAN
BANK®

July 13, 1988

Bob Harvey • Vice President

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and for (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

It is my position that the proposed bill would not be in the best interest of employees and their employers. ESOPs offer great incentives to employers and employees and promote more efficiency and productivity. Given the sad state of our country's competitive in the world market place this bill appears to be a loaded gun pointed at our own feet. The proposed bill would add much more cost and red tape to an already complex and expensive benefit plan. My fear is that if such a proposal were instituted, it would severely limit future employer interest.

Sincerely,

Vice President/Manager

/dkn

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
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SVE

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TELEX: 724389 TELSPAN SKO ATT SVE

July 12, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance- Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox:

RE: Statement for Committee's July 12 Hearing Record on S.2078, Requiring a majority of employees to approve the establishment of an ESOP.

This letter with four copies is sent to you for inclusion in the printed record of the July 12, 1988 hearings conducted by the Senate Finance Committee on the subject referenced.

Please let the record show that I am opposed to the amendments to the IRS Code which are included in S.2078. We became an ESOP company just recently and it could not have been done with the requirements of this S.2078 amendment. There are two vital reasons for my opposition: 1) time -- a hostile competitor is given an advantage under this amendment; 2) the degree of knowledge needed to vote intelligently cannot be acquired by most workers over a brief period. The alternative to an ESOP for our company would have meant the loss of 150 jobs and the loss of retirement benefits for a large number of dedicated long-term employees.

This amendment is meritless and should be defeated.

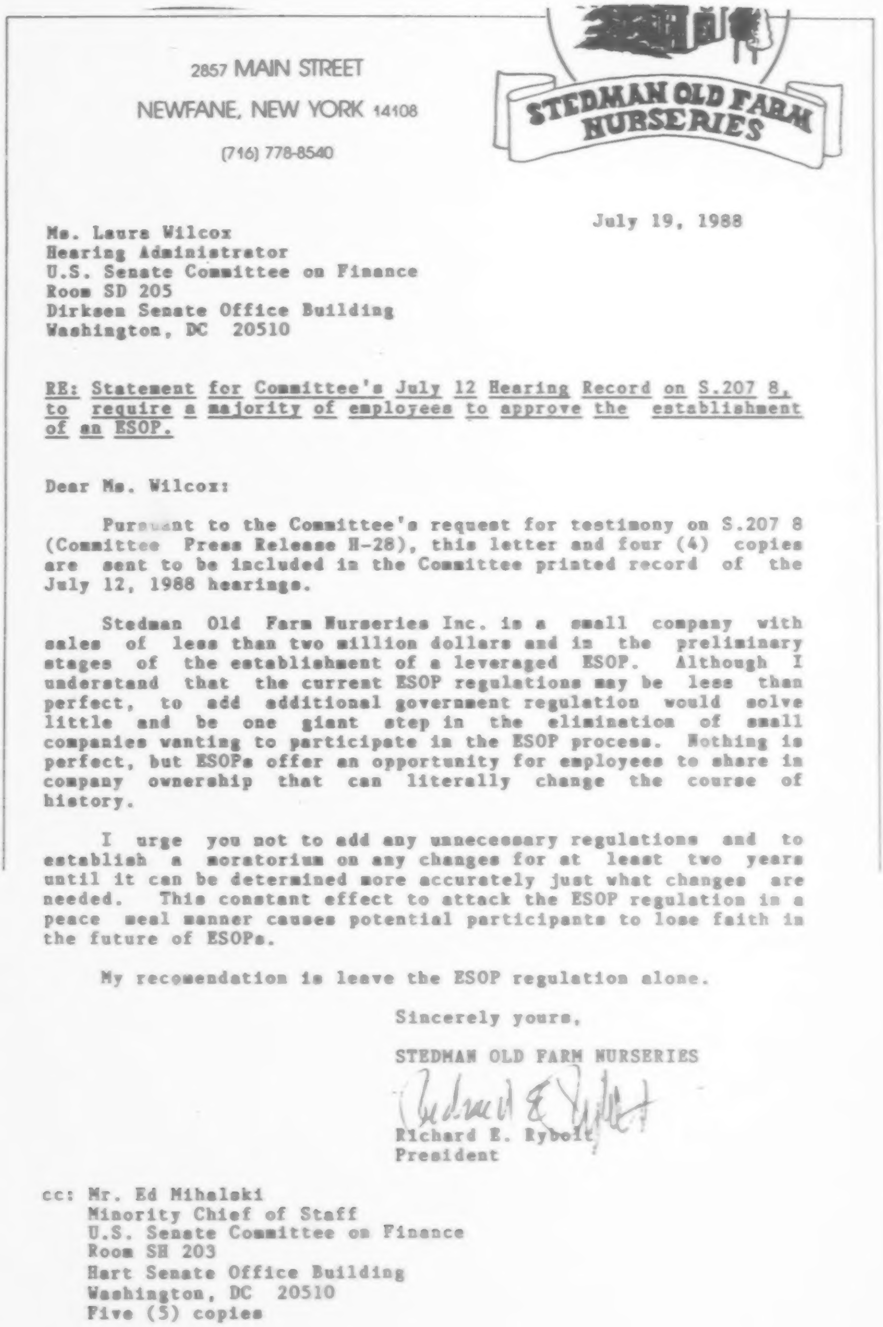
Sincerely,

Suzanne T. Isaacs
President

STI:h
Enc.: 4 copies

cc: Mr. Ed Mihalski (w/4 copies)
Minority Chief of Staff
U.S. Senate Committee on Finance - Room SH 203
Hart Senate Office Building
Washington, D.C. 20510

2707a



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STEDMAN OLD FARM NURSERIES

July 19, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.207 8, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.207 8 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

Stedman Old Farm Nurseries Inc. is a small company with sales of less than two million dollars and in the preliminary stages of the establishment of a leveraged ESOP. Although I understand that the current ESOP regulations may be less than perfect, to add additional government regulation would solve little and be one giant step in the elimination of small companies wanting to participate in the ESOP process. Nothing is perfect, but ESOPs offer an opportunity for employees to share in company ownership that can literally change the course of history.

I urge you not to add any unnecessary regulations and to establish a moratorium on any changes for at least two years until it can be determined more accurately just what changes are needed. This constant effect to attack the ESOP regulation in a peace meal manner causes potential participants to lose faith in the future of ESOPs.

My recomendation is leave the ESOP regulation alone.

Sincerely yours,

STEDMAN OLD FARM NURSERIES

Richard E. Rybolt
President

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
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THE SUQUAMISH TRIBE
P.O. Box 498 Suquamish, Washington 98392

July 20, 1988

The Honorable Max Baucus
706 Hart Senate Office Building
Washington, DC 20510
ATTN: Tim Vettel

Dear Senator Baucus:

I submit this letter and the enclosed Interior Department Solicitor Richardson's March 1985 opinion for inclusion in the July 12, 1988 hearing record on H.R. 2792 "Indian Fishing Rights Clarification" bill before the Senate Finance Committee's Subcommittee on Taxation and Debt Management hearing on "Miscellaneous Tax Bills."

We urge you to support H.R. 2792, the "Indian Fishing Rights Clarification" measure currently before the Senate Finance Committee. This bill would effectively halt the IRS attempts to impose taxes on Tribal fishermen's income derived from fishing in treaty-designated waters. This diminishment of our treaty right and violation of our treaty-reserved provision is unacceptable by legal and moral principles.

The House-passed version of H.R. 2792 unfortunately contains a provision which states that the legislation, not our treaties, are the source of the tax exemption. This sweeping assertion threatens a basic canon of Indian law, the "Reserved Rights" Doctrine. This legally tested principle states that the Tribes granted certain rights to the United States, but reserved all other rights for themselves. *United States* v. *Winans* 198 U.S. 371, 381 (1905)

We recommend in all fairness that the statute and report reflect that the H.R. 2792 and our treaties are co-extensive regarding this rightful exemption. We seek no broader or expanded fishing right exemption, but do not want the Congress to limit or diminish our treaty right. Our recommended statute language is underlined below as added to the current statute:

> The provisions of any law, Executive Order, or treaty which secure any fishing right for any Indian Tribe shall not be construed to provide an exemption from any tax imposed by this title *which is any broader than the exemption recognized by this section.*

The U.S. Tax Court and IRS have clearly broken the treaty commitment of the United States. A treaty which, according to the Constitution, is to be considered the "Supreme Law of the Land." We very clearly reserved the fishing right for ourselves in the treaty. According to John Taylor, the interpreter during the negotiation on the Treaty of Point Elliott in 1855, Governor Stevens, representing the United States said:

> "There will be witnesses. These witnesses will be the tides. You Indians know that the tide goes out and comes in, that it never fails to go in or out; you people know that streams that flow from

> the mountains never cease flowing, flow forever; you people know the sun rises and sets and it never fails to do so. Those are my witnesses and you Indians, your witnesses, and these promises will be carried out, and your promises to me and the promises the Great Father made to you will be carried out as long as these three witnesses continue -- the tide to go in and out, the streams to flow, and the sun to rise and set."

Interior Department Solicitor Richardson in the enclosed 1985 opinion refutes the Treasury Department contentions on this IRS action and their "failure to address the treaties which are at the heart of the issue under discussion."

We urge your support for H.R. 2792 to ensure that the promises made long ago are preserved. We ask that treaties, Executive Orders, and acts of Congress with respect to Indian Fishing Rights be clarified, not diminished.

Sincerely,

Georgia C. George

Georgia C. George
Chairwoman

United States Department of the Interior

OFFICE OF THE SOLICITOR
WASHINGTON, D.C. 20240

MAR 12 1985

BIA.IA.0177

MEMORANDUM

To: Secretary

From: Solicitor

Subject: Federal income taxation of Stevens treaty fishing income--Response to IRS opinion of November 23, 1983

You have asked me to comment on the legal arguments made in an opinion of the Office of Chief Counsel, Internal Revenue Service, dated November 23, 1983. The IRS opinion was issued in response to Solicitor Coldiron's memorandum of September 21, 1983, which expressed his view that income earned by members of certain Washington State treaty tribes in the exercise of their treaty fishing right is not subject to federal income taxation. The Internal Revenue Service takes the position that such income is subject to federal income taxation.

I have already conveyed to you my reconfirmation of Solicitor Coldiron's 1983 opinion. In my view, the principal weakness of the IRS response to that opinion is its misapprehension of the Supreme Court's holding in *Squire v. Capoeman*, 351 U.S. 1 (1956). The IRS considers *Capoeman* to require an *express* exemption from federal tax. However, the General Allotment Act, which the Supreme Court construed in *Capoeman* to have created a tax exemption for income from the sale of timber on allotted land, did not contain such a tax exemption in explicit terms. The Court inferred an exemption from the government's undertaking, expressed in section 5 of the act, 25 U.S.C. § 348, to convey the allotment at the end of the trust period "free of all charge or incumbrance whatsoever" and a 1906 amendment to section 6 of the act, 25 U.S.C. § 349, which provides for removal of "all restrictions as to . . . taxation" after issuance of a fee patent. That language, construed in conjunction with the underlying purpose of the General Allotment Act, i.e., "to protect the Indians' interest and 'to prepare the Indians to take their place as independent, qualified members of the modern body politic'", was sufficient, the Court held, to constitute the clear expression necessary to create a tax exemption. 351 U.S. at 6-9. See our 1983 opinion at 5-7.

The Internal Revenue Service takes the position that the policy underlying the Stevens treaties is not relevant to the determination of whether the treaties created a tax exemption. In so doing, the IRS ignores the practice established by the Supreme Court in Capoeman and followed consistently by the lower courts. That practice requires the identification of language in a treaty or statute which is arguably a tax exemption but then allows consideration of the underlying purpose of the enactment for the purpose of interpreting the arguable language to determine its tax exemption effect. The practice is discussed at some length in our 1983 opinion at pages 5-9. The proper role of policy in tax exemption analysis was succinctly described by the Ninth Circuit in United States v. Anderson, 625 F.2d 910 (9th Cir. 1980) cert. denied, 450 U.S. 920:

> Capoeman and every other Supreme Court and Ninth Circuit case have held that . . . policy arguments are fruitless in the absence of statutory or treaty language that arguably is an express tax exemption. Such policy arguments, however, might persuade courts to construe such arguable language, if any exists, actually to be an express tax exemption.

625 F.2d at 914, n.6. IRS quotes this statement from Anderson for the proposition that express exemptive language in a treaty a statute is required. IRS opinion at 6-7. It misses, however, the real thrust of the statement, which is that policy may indeed be examined to assist in the determination of whether arguable language is an express exemption.

In a recent decision, the Ninth Circuit demonstrated that it is still of the view that the purpose of a statute is relevant to the determination of whether a tax exemption is present. That court held in Karmun v. Commissioner, 749 F.2d 567 (9th Cir. 1984), that income from the sale of reindeer or reindeer products by Alaska natives was not exempt from federal income tax because the Reindeer Act, 25 U.S.C. §§ 500-500n, did not contain a clear expression of intent to exempt. The court considered, inter alia, the purpose of the Reindeer Act, which it found to be the provision of a continuing food source to the Eskimos of northwestern Alaska through the establishment of a native-operated reindeer industry. The court concluded, "That purpose is not undermined by requiring the owners and operators of the reindeer herds to pay federal income taxes on their profits from the successful conduct of such operations." 749 F.2d at 570.

Thus, it is amply clear that past and present judicial analysis requires a consideration of the underlying purpose of the Stevens treaties in order to determine whether the language in the treaties which secures a fishing right to the tribes creates a tax exemption. To conclude that the "right of taking fish" does not include a tax exemption, without any attempt whatsoever to determine the scope of the fishing right intended by the parties to the treaties, would directly contravene the well-established principles of the tax cases. Authoritative judicial analysis of the scope of the treaty right is readily available in the well-developed body of law culminating in the Supreme Court's decision in *Washington v. Washington State Commercial Passenger Fishing Vessel Ass'n (Fishing Vessel)*, 443 U.S. 658 (1979). In my view, there is neither a legal basis nor a practical justification for ignoring this body of law, as IRS does.[1]

The treaty cases and their relevance to the tax exemption issue are discussed in our 1983 opinion at 2-4 and 9-12. One case cited in that opinion warrants some further mention. In *Tulee v. Washington*, 315 U.S. 681 (1942), the Supreme Court held that the State of Washington was precluded from imposing a license fee upon Indians engaged in the exercise of their Stevens treaty fishing right. In striking down the fee, the Court stated that it "acts upon the Indians as a charge for exercising the very right their ancestors intended to reserve" and "that such exaction of fees as a prerequisite to the enjoyment of fishing . . . cannot be reconciled with a fair construction of the treaty." 315 U.S. at 685.

Tulee involved a state license fee and not a federal tax. The rationale of that case, however, is relevant to any tax which would diminish the value of the treaty right because any such tax would necessarily be a "charge" for exercising the right. An income tax, in fact, might well be a more onerous burden on the right, because greater in amount, than a license fee would be. Further, the fact that an income tax does not fall directly upon the fishing activity but upon income therefrom is, under *Capoeman*, irrelevant if the treaty precludes taxation of the fishing right.[2] *See* 1983 Solicitor's opinion at 7.

Another concern I have with the IRS opinion is its heavy reliance on *Strom v. Commissioner*, 6 T.C. 621 (1946), *aff'd per curiam*, 158 F.2d 520 (9th Cir. 1947) and *Earl v. Commissioner*, 78 T.C. 1014 (1982). For the reasons discussed in our 1983 opinion at 12-15, I believe that *Strom* has been effectively eroded by subsequent case law and that *Earl* is seriously flawed. While these two Tax Court cases are clearly relevant to the present issue, they cannot be considered controlling because they are completely inadequate in treaty analysis.

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[1] IRS simply dismisses it: "The non-tax cases which are cited by Interior are, in our view, inapposite to the issue considered herein." IRS opinion at 10.

[2] The State of Washington recognizes that treaty fishermen are immune, even though not expressly exempted, from a state fish sales tax. *See Washington Dept. of Fisheries v. DeWatto Fish Co.*, 660 P.2d 298, 301 (Wash. Ct. App. 1983). Such a tax, of course, is one which, like an income tax, would attach after exercise of the fishing right and would not therefore be a prerequisite to exercise of the right.

As explained in our 1983 opinion at page 4, the United States, absent exercise by Congress of its power to abrogate treaties, is subject to the same limitations as the states with regard to the Indians' treaty rights.

I can understand that, from the perspective of the IRS, this matter may appear to be solely a tax issue, with respect to which Tax Court decisions might be considered controlling and federal tax cases might constitute the sole appropriate body of law by which to analyze the issue. This is not only a tax issue however; it is also an Indian treaty issue. There are two bodies of law which must be considered in relation to each other. The controlling cases here are not the two Tax Court cases but the two Supreme Court cases, *Capoeman* and *Fishing Vessel*, which represent the paramount authority in those two bodies of law. A proper analysis of the issue should begin with those cases and must relate the two bodies of law in proper perspective. This, IRS simply has not done.

I am somewhat concerned with some erroneous statements made in the IRS opinion about positions taken in our 1983 opinion. I point these out primarily for clarification purposes.

The IRS opinion states at page 6 that our 1983 opinion "argues that Interior Department's policies of promoting optimal land use on Treaty land with a goal towards eventual Indian economic independence precludes taxation of the fishing income earned by enrolled Tribal members." The 1983 opinion contains no such statement. Nor does it take the position, as the IRS opinion implies, that policy, standing alone, is a sufficient basis for a tax exemption. Our position on the proper role of policy is discussed above and at pages 5-9 of the 1983 opinion.

The IRS opinion states at pages 7-8 that "Interior's memorandum also places substantial reliance on the Ninth Circuit's statement in *Stevens v. Commissioner*, 452 F.2d 741, [746] ([9th] Cir. 1971), to the effect that as the agency charged with the administration of the Indian laws and responsible for drafting many of them, Interior's interpretation is entitled to 'great weight' and 'is not to be overturned unless clearly wrong.'" The IRS memo then proceeds at some length to construe the *Stevens* statement as applicable only to the facts at issue in that case. While our 1983 opinion cited the *Stevens* case for another proposition, it did not, in fact, cite or rely on the language quoted by IRS. That language, however, simply expresses a well-established general principle, and I find it somewhat puzzling that IRS considers it so alarming. This Department's authority to interpret federal Indian statutes and treaties derives from its paramount responsibility for Indian affairs within the federal government, just as the authority of the IRS to interpret the federal tax laws derives from its responsibility to administer those laws. Courts commonly look for guidance to federal agency interpretations of statutes within the jurisdiction of the agencies.

These last two points are minor ones, of course. My primary objections to the IRS opinion are, as discussed above, its incorrect analysis of *Squire v. Capoeman* and its failure to address the treaties which are at the heart of the issue under discussion.

Frank K. Richardson

Frank K. Richardson

Ternary Corporation
6862 Elm Street, Suite 390, McLean, Virginia 22101, (703) 448-0731

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

RE: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

I, as President of Ternary Corporation, strongly object to the requirement of a majority of employees to approve the establishment of an ESOP. Ternary Corporation performs administration and recordkeeping services for Defined Contribution Plans - an ESOP being one type of plan. The federal tax and reporting requirements are already confusing, burdensome and expensive for plan sponsors. I need only to examine what has overtaken the administration of 401(k) deferred compensation plans to strongly urge that this bill (S.2078) be rejected. Benefit plan administration has become very complex and has done very little to effect in a positive way, the benefits for a participant. On a straight cost effective analysis, this bill fails.

Thank you for the opportunity to express my professional opinions.

Sincerely,

George C. Schnitzer

George C. Schnitzer
President

cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

STATEMENT BY
NMTBA - THE ASSOCIATION FOR MANUFACTURING TECHNOLOGY
TO THE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
UNITED STATES SENATE
JULY 12, 1988

I. INTRODUCTION

NMTBA - The Association For Manufacturing Technology, is a trade association which currently represents over 300 machine tool building firms with over 400 plant locations.

Our members are engaged in the business of manufacturing the tools of metalworking productivity including cutting, grinding and forming machines, universal measuring machines, and automated production systems. Although the industry is relatively small by some corporate standards, America's machine tool builders account for a very basic and strategic segment of the nation's industrial capacity. Our industry builds the machines essential to our military readiness and our ability to respond quickly and effectively in the event of a national emergency. Our product is the very essence of the industrial manufacturing process. We produce the "tools of production."

One of the keys to maintaining the security of the United States is a strong, national commitment to research and development. That is why NMTBA supports S. 2484, the Research and Experimental Credit and Extension Act of 1988. We believe that this legislation sends a strong signal to American industry -- a signal which clearly indicates that America's position of technological leadership in the world is a compelling national priority. In our view, this is precisely the right signal to be sending, and NMTBA applauds this timely and important initiative by Senators Danforth and Baucus.

II. STATUS OF THE MACHINE TOOL INDUSTRY

Before proceeding with comments concerning specific provisions of S. 2484, a brief overview of the U.S. machine tool industry is in order. It has already been stated that a weakened machine tool industry is a threat to the stability of this country's industrial base and jeopardizes the national security of the American people.

In fact, our industry is struggling. Recent reports of a recovering manufacturing sector and, specifically, increases in machine tool orders are misleading. Yes, orders have risen. Yet, foreign imports continue to penetrate domestic markets at alarming levels. The most vulnerable of these domestic markets are machining centers, and numerically controlled turning machines and punching machines. These classes of machine tools are the "high tech" defense-sensitive tools which are vital components of flexible manufacturing systems and "factories of the future." Automated machine tools within automated plant models will provide efficient and competitive production facilities for peacetime manufacturing, and perhaps more importantly, the military readiness that America needs to prepare for and to deter global conflict.

In spite of hardships, the U.S. machine tool industry's commitment to research and development, measured as a percentage of sales, is among the highest of any industry. Numerical control, computer control, flexible manufacturing systems, and a host of other advanced machine tool technologies were all invented in the United States, and more of these advanced technology machines have been built by U.S. machine tool builders than by any other nation.

A recent study conducted by the Joint Trade Association Committee on Industrial Automation Market Statistics, of which NMTBA is a member, uncovered some interesting trends. The study illustrates that, in 1980, 15 percent of all automation was purchased by small businesses. By 1995, however, it is predicted that these small companies will account for 34 percent of all automation purchases.

According to the 1983 American Machinist Inventory of Metalworking Equipment, the machine tool industry reflects these trends. American Machinist points out that, in 1983, 5 percent of the machine tools on the shop floors of small companies were numerically controlled. A figure comparable to the level of automation in large companies at that time. Of that five percent, over half of the numerically controlled machines were bought between 1979 and 1983. Obviously, the trend is toward an automated factory of the future.

These figures suggest that the demand for technologically advanced products will continue to grow at a rapid pace and that small business will contribute substantially to that trend. This will place even greater competitive pressures on our industry, as Japanese and other foreign producers target cur domestic market!

During the last two and a half years, Hughes Aircraft Company, L.T.B., Watervliet Arsenal, General Dynamics Corporation, and Lockheed Aircraft Corporation have purchased flexible manufacturing systems costing \$12-\$14 million each from U.S. machine tool builders. The systems were competed internationally and the U.S. manufacturers were not the lowest bidders. If foreign technology was superior to that of the U.S. machine tool industry, you can be sure the foreign builders (with their lower bids) would have gotten these orders.

The charge has been made that we are on old, inefficient, "smokestack" industry which has not kept pace with other nations in advanced machine tool technology. However, a recent study by The Machine and Tool Blue Book emphatically states -- "in the opinion of America's manufacturing engineers, America's machine tool builders are tops in technology."

The need for new technologies in all fields has been established. However, the machine tool builder faces many obstacles which impede research and development. One obstacle is the current structure of the R & D tax credit, which makes it virtually unusable by most of our members and many other small businesses and slow growth industries as well. S. 2484 reforms the structure of the R & D credit, and we strongly support it for that reason.

III. THE RESEARCH AND EXPERIMENTAL CREDIT AND EXTENSION ACT OF 1988

Our industry is struggling to maintain its competitive edge, both at home and abroad. And like many other industries, the U.S. machine tool industry has been substantially affected by rapid advances in technology and in manufacturing processes -- particularly with regard to computer-assisted design and manufacturing. Thus, expenditures for research and development are the lifeblood of the machine tool business. In order to compete effectively in domestic and export markets, the industry must retain the ability to continue and increase its R & D expenditures.

The House Ways and Means Committee has voted an extension of the current R & D tax credit for two additional years in the Technical Corrections Act of 1988. NMTBA supports this extension as a symbol of the federal government's recognition that continued investment in research and development is essential in maintaining this nation's competitive edge.

However, there have been inequities associated with the structure of the credit since its inception. Small businesses, start-up ventures, and slow or negative growth companies have never been able to fully utilize the credit's benefits. These are the very types of firms, which studies suggest, are the most innovative. The result is a tax credit which provides maximum benefit for the large, fast growth companies who invest in research and development but which offers little or no incentive to the small, slow growth companies, such as NMTBA members, who need the credit the most.

S. 2484 addresses these concerns in a number of ways. Most importantly, it replaces the current credit's three-year moving base-period with a five-year fixed base period indexed for GNP. The fixed base serves to redirect a portion of the credit's benefits away from fast growth companies and toward slow or negative growth companies. The fixed base also encourages continued expansion of R & D spending every year, unlike the moving base period where a slow down in R & D spending one year could mean greater benefits in years to come.

Another important provision of S. 2484 is the creation of the two-tiered credit structure. This allows a firm to choose each year between a primary credit and a secondary credit with a reduced base. In this way, companies can utilize a portion of the credit in periods of reduced investment and can obtain maximum benefit in years of peak R & D investment. S. 2484 also extends the R & D tax credit to start-up firms that are presently excluded from using the credit.

Finally, S. 2484 makes the R & D credit permanent. A benefit to all companies, large and small. This provision adds a crucial element markedly absent from R & D planning which is now underway -- the element of certainty. A permanent credit significantly enhances the abilities of all businesses to make the necessary R & D investments to remain competitive here and abroad. The sooner the certainty can be established, the sooner manufacturers and others will be able to factor the availability of the credit into both long and short-range planning.

All of the provisions described above work to encourage R & D spending in every type of business. This ensures that the greatest amount of technological research will be undertaken in every field.

IV. CONCLUSION

We realize that enactment of this legislation results in a 25 percent greater loss of revenue to Treasury than current law. However, just as the U.S. machine tool industry views research and development expenditures as an investment in its future, we are hopeful that members of this Subcommittee will view S. 2484 as an investment in America's future.

It is evident that more efficient production technologies must necessarily be developed if the United States is going to compete successfully in an expanding global market. The American machine tool industry stands ready to do its part. But we and our customers need the added incentive and cash-flow an improved R & D tax credit will provide. We urge the Congress to grant such a credit.

MAPI COMMENTS ON S. 2484
THE RESEARCH AND EXPERIMENTAL TAX CREDIT
to the
Subcommittee on Taxation and Debt Management
# of the
Senate Committee on Finance

As the subcommittee continues to consider the future of the Research and Experimental Tax Credit, MAPI appreciates this opportunity to express its support for S. 2484, the Research and Experimental Credit Extension and Reform Act of 1988, proposed by Senators Danforth and Baucus. MAPI is a policy research institute whose 500 member companies are drawn from a broad spectrum of industrial corporations. Our membership is comprised of firms engaged in heavy industry, electronics, precision instruments, telecommunications, chemicals, aerospace, and related high-technology industries. The Institute conducts original research in economics, law, and management and provides professional analyses of issues critical to the economic performance of the private sector. MAPI also acts as a national spokesman for its member companies, concerning itself with policies that stimulate technological advancement and economic growth for the benefit of U.S. industry and the public interest.

Why an Improved Permanent R&D Tax Credit Is Essential

The manufacturing sector is only now emerging from a very difficult period. The combination of back-to-back recessions, increased international competition, and outmoded plant and equipment have taken a long time to overcome. A major contributor to the turnaround has been the adoption by manufacturers of new technology, both in what they produce and how they produce it. On the national level, we are beginning to see this improvement in competitiveness reflected in the international trade statistics. For the following reasons, a more effective R&D tax credit is critical to guaranteeing that the economic performance of U.S. manufacturing will continue to improve well into the future.

- On its own, industry will always underinvest in R&D./1

  It is well recognized that without government incentives the private sector will not invest sufficiently in R&D, since it is impossible for those conducting the research to capture all of the social benefits arising from the investment.

- R&D expenditures represent a long-term investment, with the payoff in the form of improved innovation typically realized only after many years.

  While the product and process innovations that have been adopted recently by U.S. industry are based, to a large extent, on our own past research investments, many of industry's innovations are imitations from our competitors. If U.S. industry is to be a leader in global markets, we must match the higher rates of commercial R&D investment of our major competitors.

Therefore, notwithstanding the current budget situation, it is critical that we not allow the research credit to lapse, especially now that the U.S. trade position is beginning to improve.

Advantages of the Research and Experimental Credit Extension and Reform Act of 1988

The reform of the existing tax credit included in S. 2484 has the following major advantages:

- By making the credit permanent, the stimulus to invest in R&D is increased.

  When a company is considering whether to undertake a new research effort, a tax credit with a limited life that may be scheduled to expire at the point where expenditures begin to increase does not provide much of an investment incentive. In addition, a firm may be tempted to undertake shorter-run research projects at the expense of longer-run projects in an attempt to maximize use of the credit while it is in effect.

- By adopting a historical base for calculating the value of the credit, the current disincentive in the existing credit is avoided.

  Under current law, the credit is applied to qualified expenditures that exceed the average of the expenditures of the prior three years. Therefore, any current additional research expenditure reduces the amount of the next year's expenditure that will be eligible for the credit. This can cause perverse investment incentives. If a firm is not going to invest in R&D in any year at a level exceeding the average of the preceding three years, it will be reducing the value of future credits by investing in research that year.

  The purpose of using the three-year moving average as a base was to encourage ever-increasing amounts of investment by the firm on a yearly basis. We believe that this is not the desirable goal. The credit should be designed to provide incentives to a firm to maintain its research investment at a level higher than it would have been, absent the credit. The fixed historical base specified in the Danforth-Baucus proposal provides for such an incentive.

- By expanding the coverage, more firms are eligible for the credit.

  In order to increase the availability of the credit to R&D-performing firms, the proposal offers an alternative method for calculation of the credit that will benefit firms whose annual expenditure is less than 100 percent of the base (but over 75 percent), or whose annual increase is small relative to the base. S. 2484 also extends the credit to new firms and new lines of business. Both of these changes will encourage research investment in areas where it should yield substantial benefits.

MAPI's Proposal for Improving the Base on Which the Credit Is Determined

The current version of the R&D tax credit is indexed in that the base is a moving average. Under the Danforth-Baucus proposal, the base period is a fixed historical base which would be indexed to nominal GNP. This means that the base increases as the sum of inflation plus real GNP increases. MAPI agrees with the inclusion of the inflation component in the index because the credit should be giving incentives only for real increases in research investment. However, we are concerned about including the other component of the proposed index, real GNP. For a firm experiencing real growth at or exceeding the rate of growth in real GNP, the erosion of the credit due to the increasing base may not be very significant. However, a firm or industry experiencing lower-than-average growth rates could lose the incentive effect of the credit at a time when it needs to be investing in research to improve its future competitiveness. MAPI therefore recommends that the Congress consider indexing the base to a measure of inflation, such as the Producer Price Index, rather than indexing to nominal GNP.

Conclusion

This bill is a substantial improvement on the existing R&D tax credit and would provide important and much-needed research incentives to the private sector. As Dennis Ross, Deputy Assistant Treasury Secretary for Tax Policy, pointed out when he testified recently before this subcommittee, by correcting the major weaknesses present in the current formulation of this credit, the Danforth-Baucus proposal would result in a $1.21 increase in R&D per dollar of revenue loss--a six-fold increase over what an extension of the current law would yield. Additionally, this proposal would expand the percentage of firms which would qualify for the credit.

Particularly given this rate of return, MAPI believes an R&D tax credit, such as that proposed by Danforth and Baucus, is an investment in the future which the United States must make in order to guarantee the continued competitiveness of our domestic industries.

1/ Investing in Innovation: The Need To Strengthen the R&D Tax Credit, G-223, MAPI, November 1987.

CHRONOLOGY OF ADMINISTRATIVE, LEGAL, AND LEGISLATIVE ACTIONS REGARDING THE LUMMI INDIAN TRIBE'S QUEST FOR JUSTICE AGAINST IRS ATTEMPTS TO DIMINISH TRIBAL TREATY-PROTECTED FISHING RIGHTS

1981 - IRS agents cite Roy Earl, a non-enrolled Indian serving as a cook on a non-Indian fishing boat, for tax evasion on commercial fishing income. Prior to his appearance in U.S. Tax Court, Earl becomes an enrolled member of the Puyallup Indian Tribe. Earl pleads innocent without legal counsel before the U.S. Tax Court on the basis of being an enrolled tribal member with treaty rights representing himself and loses the case.

1982 - IRS agents, utilizing the Earl v. Commissioner precedence, cite 60 Lummi tribal commercial fishermen for Federal income taxes from 1978 to present. The Lummi Indian Tribe vigorously protests the IRS actions as their 1855 Treaty of Point Elliott reserved for the Tribe and its members the right to fish in their "usual and accustomed" waters. The U.S. Tax Court continues to cite and process Tribal fishermen.

1983 - Interior Department Solicitor Coldiron issues an opinion in September 1983 clearly determining that the Treasury Department action unlawfully diminishes the treaty right. Treasury Department Associate Solicitor Keightley releases a counter-opinion contending that the Tribe should have included tax exemption language in their treaty of 1855. One should note the first Federal income tax laws were enacted in 1916 or 61 years after the signing of the Treaty of Point Elliott. The U.S. Tax Court continues to cite and process Tribal fishermen.

1985 - Interior Department Secretary Hodel sends a 2/22/85 appeal letter to Treasury Secretary Baker supporting the Tribal treaty-protection position and seeking a resolution of the intra-department dispute. With no Treasury Department response, Secretary Hodel sent a 3/22/85 letter to Attorney General Meese seeking resolution of the intra-departmental dispute accompanied by a March, 1985 Interior Department Solicitor Richardson opinion refuting the Treasury Department opinion on Indian Fishing Rights. In December, 1985 the Justice Department Deputy Assistant Attorney General Gerson ruled that the Treasury Department position was "the sounder view of the law." This ruling effectively stripped the Interior Department capability to support tribal governments in court proceedings. The U.S. Tax Court continues to rule against Indian commercial fishermen and the IRS begins collection enforcement.

1986 - In July 1986, Senator Bill Bradley and thirty-two bipartisan Senate co-sponsors sent a letter to the Justice Department on this issue urging the Department "to reverse this ill-conceived policy without delay." The Justice Department responded that the Congress or Courts should resolve this controversy. On August 1, 1986, Senators Dan Evans and Bill Bradley introduced an amendment to the Debt Ceiling Bill (H.J. Res. 668) clarifying that tribal members' income derived from fishing in treaty-protected waters was not subject to Federal income taxes. Passed by the U.S. Senate, this amendment was stripped along with all other amendments in the House-Senate conference in October, 1986.

1987 - Senator Dan Evans, joined by seven co-sponsors introduced S. 727 on March 12 to clarify Indian Fishing Rights reserved by treaty. In a March 27 hearing before the Senate Select Committee on Indian Affairs, Interior Department Assistant Secretary - Indian Affairs Ross Swimmer, testifying on behalf of the administration, supported passage of S. 727. S. 727 passed the Senate on May 13, 1987 and was referred to the House of Representatives. After intervention by Senate co-sponsors to avoid confrontation, the IRS agreed to withhold collection proceedings for a "reasonable period of time" while Congress considered clarifying legislation.

The House Committee on Interior and Insular Affairs claimed jurisdiction of S. 727 as a treaty-clarification measure. The House Committee on Ways and Means, claiming jurisdiction of the issue as revenue measure, rejected the Senate bill due to the Constitutional provision that all revenue measures begin in the House of Representatives. H.R. 2792 "Indian Fishing Rights" legislation was introduced by Congressman Mike Lowry (D-WA) and seven bi-partisan co-sponsors on June 25th. The bill was jointly referred to the Committees on Interior and Insular Affairs as well as Ways and Means. The Committee on Interior and Insular Affairs held a hearing on July 21, 1987 on the measure in which Interior Department Assistant Secretary Swimmer testified again on behalf of the administration supporting passage of H.R. 2792. The bill was favorably reported under unanimous consent by the Committee on Interior and Insular Affairs the same day. The Committee filed its report on September 21, 1987.

The Select Revenue Measures Subcommittee of the Committee on Ways and Means, held a hearing on H.R. 2792 on December 14, 1987. The Treasury Department, testifying for the first time on this issue, gave qualified endorsement on this legislation suggesting unemployment and social security taxes should be applied to tribal fishermen's income as a humanitarian consideration. Tribal governments unanimously opposed this contention as a continued effort to diminish treaty rights. The U.S. Tax Courts continue to cite tribal fishermen and expand their efforts into Michigan.

1988 - The Select Revenue Measures Subcommittee reported H.R. 2792 to the full Committee on Ways and Means on March 17, 1988. On June 9, 1988 the full Committee on Ways and Means favorably reported H.R. 2792 and voted to reject S. 727 to be returned to the Senate as an infringement on House privileges. S. 727 and the original H.R. 2792 passed by the Committee on Interior and Insular Affairs focused on clarification that the Tribally-reserved treaty fishing rights provision established the exemption. The Committee on Ways and Means redrafted H.R. 2792 for the Internal Revenue Code inferring in a protective clause to inhibit future treaty fishing rights exemption claims that the legislative measure created the exemption. H.R. 2792 was passed by the House of Representatives under suspension of the rules on June 20, 1988. The U.S. Tax Court continues to cite and process tribal fishermen.

H.R. 2792 was referred by the Senate parliamentarian to the Senate Finance Committee. The Subcommittee on Tax and Debt Management held a hearing July 12, 1988 on "Miscellaneous Tax Bills," including H.R. 2792. Senator Evans, the original sponsor of S. 727, testified at the hearing that the provision limiting the tax exemption to the legislation rather than the treaty was an implied abrogation of the "Reserved Rights" canon of Indian law; namely, any rights not granted by the Tribes in their treaties with the United States are still held by the tribes. The Tribes testified that the legislative exemption is co-extensive with the treaties. The Treasury Department testified in support of H.R. 2792 with the exclusionary clause providing the legislation as the sole source of exemption.

STATEMENT OF HERMAN A. WILLIAMS, SR., CHAIRMAN
THE TULALIP TRIBES OF WASHINGTON
ON
H.R. 2792
A BILL TO CLARIFY INDIAN TREATIES AND EXECUTIVE ORDERS WITH RESPECT TO FISHING RIGHTS
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 12, 1988

My name is Herman A. Williams, Sr. I am Chairman of the Board of Directors of the Tulalip Tribes of Washington. On behalf of the Board, I would like to thank you and the Committee for this opportunity to present the views and recommendations of the Tulalip Tribes concerning H.R.2792, a bill to clarify the non-taxable status of income derived from the exercise of fishing rights secured by treaties and Executive Orders. We commend the co-sponsors for introducing this vital Indian measure and the Committee for holding this hearing.

In our view, this legislation will reaffirm the meaning and intent of the treaties entered into between the government of the United States and Washington Indian tribes in 1855 and will confirm the Federal Government's trust responsibilities under those treaties. The Tulalip Tribes recommend passage of H.R.2792 in its present form. Its enactment will stand as a clear signal to all that the United States honors its word.

Mr. Chairman, I would like to note in passing that President Reagan recently signed a treaty with the Soviet Union. Our treaties were not signed recently, but to us they are as fresh and binding as if they had been ratified this morning.

If after all these years the Internal Revenue Service, with the support of the United States Department of Justice, can arbitrarily, retroactively and unilaterally reinterpret the intent of our treaty, what faith or security can any nation have in the solemn pledges of the Federal Government?

The Tulalip Tribes of Washington are the descendants of several of the tribes and bands which signed the Treaty of Point Elliott on January 22, 1855. We have reserved treaty fishing rights under that Treaty. For centuries, fishing and hunting were central to the way of life of my ancestors. Fishing was the cultural, religious and economic mainstay of our people for centuries before the treaties. It served to give us a rich and varied life as well as a firm economic base.

We have already suffered great losses. In the treaties, we ceded large areas of land and agreed to a small reservation of 22,000 acres of land in return for our reserved fishing rights. The United States' promises that the treaties would protect that source of food and commerce in perpetuity were crucial in obtaining the tribes' agreement to the treaties. The negotiators for the United States recognized the importance of fishing to our economy, this point was stressed throughout the negotiations.

Today, with only approximately 8,000 acres left in tribal ownership to serve as a base from which to exercise our fishing rights, fishing continues as it did in treaty times to serve as the mainstay of our cultural and religious practices and our economy. When asked how many of our members are fishermen, we often say that we are all fishermen. Our children, as they grow up, learn to fish - much as we did, and, as our forefathers did.

Even for those of us who work at some other trade, fishing provides part of our subsistence and serves as an important cultural and religious event. For some, fishing is a part-time job. But fishing, even with more modern gear and methods, is a difficult activity. Those who make their living from fishing do so at a tremendous investment of time and effort and can ill-afford to have this treaty right taxed. I speak from first-hand experience since I have over thirty years background as a fisherman and a broker in the marketing of salmon.

Mr. Chairman, the United States assured the tribes that the treaties would "secure" their fishing rights. Governor Stevens, the chief negotiator for the United States, stated at the time, "This paper gives you a home.... This paper secures your fish." In fact, the fishery is the principal economic resource reserved under the treaties by Western Washington tribes. The vital economic importance of the fishery to us has not diminished with the passage of time.

On the Tulalip Reservation, and on other reservations throughout the Northwest, fishery income often supports an extended family. Brothers, sisters, cousins, nephews and nieces may spend some or all of their time engaged in fishing. We wish to encourage this since it continues our way of life and provides a means of livelihood free from government welfare programs.

Historically, both the tribes and the United States have recognized that treaty fishing income is not subject to taxation. In 1942, the Supreme Court of the United States agreed with us that a state cannot impose a charge upon the exercise of our fishing right and held that the treaty prohibited this. The same principle applies to the United States. The Solicitor of the Department of the Interior recently reaffirmed the long-accepted understanding that treaty fishing income is not subject to Federal taxation. Indeed, until its recent policy reversal, the Internal Revenue Service historically did not apply the Federal income tax to treaty fishing income.

Frankly, we were caught by surprise when the IRS began to try to collect tax on our income from treaty fishing. Our ancestors helped the United States achieve peace in the Northwest Territory during treaty times. The United States made a bargain with us. The action of the IRS makes us feel a deep sense of betrayal. We have always believed, and continue to believe, that the United States Government acted in good faith when it promised our forefathers that the fishing rights would not be impaired in any way.

Let me say here that as co-managers of the fishery we are acutely aware of and believe in the necessity of assuring conservation of the resource. We also believe, and H.R.2792 will reaffirm, that Congress did not intend to abrogate any part of the treaties when it passed the Internal Revenue Code.

In our opinion, the honor of the Nation is involved in this issue. We urge that the Internal Revenue Service's approach to dealing with treaty commitments and trust responsibilities be strongly rejected. All Federal agencies, including the Internal Revenue Service, share the Federal trust responsibility to protect the tribes' treaty fishing rights. If the approach of the IRS in this matter is adopted, all treaty rights and trust resources will be in danger.

Speaking of the Federal trust responsibility, let me point out that over the past years we have seen many government welfare and jobs programs come and go. The most cost-effective job program to encourage economic self-sufficiency among our people is to sustain our treaty fishing right free from government taxation. President Reagan in his Indian Policy Statement of January 24, 1983, highlighted the importance of economic development and self-sufficiency and mentioned fishing as an avenue to tribal economic development.

The Internal Revenue Service and the Justice Department seem to have placed themselves over and above the stated policy of the President. A Federal income tax on our fishery income would drive some of us out of business. Many of our members currently pay a tribal tax on their earnings from fishing activities and imposition of a Federal income tax on those same activities would greatly impair our ability as a tribal government to impose and collect a tribal tax which is an important source of income to our tribal governments. This income goes to support search and rescue, marina maintenance, fisheries patrol and fisheries enhancement.

We support the House-passed bill. We do, however, have concerns about some aspects of it. I am particularly concerned that language in the report (Report 100-312, Part 2 to accompany H.R. 2792) related to the definition of "fishing rights related activity" could arguably be construed as not exempting income of a tribal member when assisted by a non-member. This language implies that only members of a tribe may exercise the fishing rights held by that tribe and be eligible for an exemption from tax on income derived therefrom. The present report language is directly contrary to Judge Boldt's holding in U.S. v. Washington that a non-member's spouse may assist in the exercise of the treaty right.

I believe that this problem can be remedied by clarification in the legislative history of H.R.2792. At the bottom of page 7, Report 100-312, Part 2, after the period in Footnote 11, add the following:

> The Committee notes that current federal laws allow an Indian exercising treaty rights to be assisted by relatives in certain cases. See, e.g., U.S. v. Washington, 384 F.Supp. 312 (W.D. Wash.1974). Income from treaty fishing is not subject to tax by virtue of a member being lawfully assisted, but any income separately derived by a non-member assisting is not exempt.

Mr. Chairman, I want to emphasize in closing that Northwest Indian tribes paid a heavy price in the bargain they struck with the Federal Government by giving up millions of acres of their traditional homelands. Our forefathers believed the treaties secured our fishing rights for all time. We modern-day leaders share that belief as well. But now the IRS in concert with the Justice Department seeks to rewrite history and reinterpret the treaties by declaring the treaty right to be fair game for a Federal tax. The House of Representatives has passed this measure overwhelmingly. We urge this Committee to move quickly for enactment of H.R.2792 in its present form to uphold the integrity and word of the Federal Government in the treaties under consideration here as well as those affecting other tribes across the country.

Thank you.

WEBB INSURANCE AGENCY, INC.
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[illegible] WEST [illegible] STREET • P.O. BOX 539 • LIMA, OHIO 45802-0539 • (419) 228-3211

July 18, 1988

Ms. Laura Wilcox
Hearing Administrator
U.S. Senate Committee on Finance
Room SD 205
Dirksen Senate Office Building
Washington, DC 20510

Re: Statement for Committee's July 12 Hearing Record on S.2078, to require a majority of employees to approve the establishment of an ESOP.

Dear Ms. Wilcox:

Pursuant to the Committee's request for testimony on S.2078 (Committee Press Release H-28), this letter and four (4) copies are sent to be included in the Committee printed record of the July 12, 1988 hearings.

I, as Administrator, object to Senator Armstrong's bill which would require an employee vote on the establishment of any ESOP, leveraged or non-leveraged. This bill would result in massive government regulations which would hamper the creation of new ESOPs. Also, the provision in the bill to require the Secretary of the Treasury to issue unspecified regulations would hamper the formation of new ESOPs and make existing ESOPs less attractive. I personally would like to know what these regulations are going to be so that I can address myself to them specifically rather than leaving the establishment to the Secretary of the Treasury.

Very truly,

WEBB INSURANCE AGENCY, INC.

Glen C. Webb, Jr.
GCWJR:pw
encl:
cc: Mr. Ed Mihalski
Minority Chief of Staff
U.S. Senate Committee on Finance
Room SH 203
Hart Senate Office Building
Washington, DC 20510
Five (5) copies

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